S. HRG. 101-1103

THE SAFETY AND SOUNDNESS OF GOVERNMENT SPONSORED ENTERPRISES—1990

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE PROBLEMS OF INADEQUATE SUPERVISION AND INSUFFICIENT CAPITAL IN THE THRIFT INDUSTRY AND ALSO TO ASSESS THE RISKS AND PROVIDE RECOMMENDATIONS FOR IMPROVEMENTS

MAY 15, 1990

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

35-603 WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S241-24

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THE SAFETY AND SOUNDNESS OF GOVERNMENT SPONSORED ENTERPRISES—1990

TUESDAY, MAY 15, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sanford, Shelby, Graham, Garn, Heinz, Gramm, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. Let me welcome this morning Under Secretary of the Treasury Robert Glauber. We have a vote underway on the Senate floor that began at 10:00, the hour to begin this hearing, so we will have members in transit for a period of time here.

As we begin this hearing this morning, I want to announce for the record that, as members arrive, they will be recording their votes on favorably reporting the nominations of David Mullins, Jr., to be a member of the Board of Governors of the Federal Reserve System, and Michael Paul Galvin to be an Assistant Secretary of Commerce. So we will begin the period for voting now, and it will extend until the hearing concludes. If a quorum is established in that time, the final vote will be announced as we adjourn and the nominations will be reported to the full Senate today.

I am going to have the clerk record me in the affirmative on both nominations, and be sure to inquire of other members as they come to the hearing this morning.

We want to welcome this morning Under Secretary of the Treasury Robert Glauber to give his views on the safety and soundness of Government-sponsored enterprises. He will be followed by Richard Fogel, Assistant Comptroller General for the GAO.

Last year we were heavily focused on the problems of inadequate supervision and insufficient capital in the thrift industry. We added to the FIRREA legislation a request of both the Treasury and the GAO to look at all our sponsored agencies and to see if there were any weaknesses in the Federal oversight system. I must say, I appreciate the work that has been done and is being done, and we will hear some of those conclusions today.

We do not yet have the full content of the studies work that have been done, but we look forward to having them. We are very inter-

ested in this subject, and my mind is very much open on the question of whether or not we may need some change in the oversight structure. To the extent that it becomes clear as we move through this material, I would very much want to talk with the Treasury Department as to what that might involve and how we might think that through.

Most GSE's appear to be profitable, well-run organizations that serve useful public purposes, but our experience with deposit insurance and with the Farm Credit System a few years ago have made clear that implicit government guarantees, including those that reassure investors about the debt of GSE's, can in fact become very explicit.

At a hearing last fall at which Mr. Glauber provided very useful testimony, we were told by Standard & Poor's that they would rate the risk to the Government stemming from the various GSE's as ranging from the upper part of investment grade to below investment grade.

Other witnesses told us that, while some GSE's appear to be reasonably well supervised, others seem to get little attention from their regulators, and one GSE has no public regulator at all.

These institutions currently have some $800 billion of securities outstanding for which taxpayers will be liable if anything were to go wrong. I think the least we can do is to make sure that we have an effective system of Federal oversight. I think that it is reasonable to require these borrowers to maintain capital that provides as much protection to taxpayers as possible without in turn jeopardizing the ability of the agencies to continue to carry out their respective missions.

The studies that provide the basis for today's testimony were designed to assess the risks and provide recommendations for improvements. I know the staffs of both Treasury and GAO have worked very hard to learn about these sponsored agencies and, for our part here on the committee, we are very interested and determined to get the full light of day on these agencies and their activities and what the financial implications might be. So we are very pleased that they are here today to so report.

So, Mr. Glauber, let me call on you, first. I know you have someone accompanying you that you will probably want to introduce to the committee.

TESTIMONY OF ROBERT R. GLAUBER, UNDER SECRETARY FOR FINANCE, DEPARTMENT OF THE TREASURY, WASHINGTON, DC, ACCOMPANIED BY MICHAEL BASHAM, DEPUTY ASSISTANT SECRETARY FOR FEDERAL FINANCE, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. GLAUBER. Thank you very much, Mr. Chairman. With your permission, I would like to ask Michael Basham, who is Deputy Assistant Secretary for Federal Finance, and who has had a major hand in the details of the study, to sit with me and, if necessary, to answer questions.

The CHAIRMAN. Very good.

Mr. GLAUBER. Furthermore, Mr. Chairman, with your permission I would like to excerpt my statement, but would ask that the entire statement be included in the record.

The CHAIRMAN. We will make it a part of the record.

Mr. GLAUBER. Mr. Chairman, it is a pleasure to be here today to discuss the results of the Treasury's first study of Government-sponsored enterprises, or as they are called, GSEs.

The recent failure of many federally insured savings and loan institutions and the massive Federal funding required to resolve the thrift problem have focused attention on other areas in which the Government may be exposed to financial risks. In this connection, section 1404 of FIRREA directs the Secretary of the Treasury to assess, in two annual studies, the financial safety and soundness of GSE's.

While we had planned to submit the study today, the need to incorporate significant new information from two of the GSE's has resulted in some delay. We will submit the first study to Congress later this month. Because our individual analyses are not available, in fairness to the GSE's, I will not comment today on the specific safety and soundness of the individual GSE's. Our comments in this area will, of course, be included in the full study.

Government-sponsored enterprises are entities which have been established and chartered by the Federal Government to perform specific credit functions, but are now, with one exception entirely privately owned. GSE's generally serve as financial intermediaries to facilitate the flow of credit to private borrowers in three areas: agriculture, housing, and higher education. They do this by raising funds in the capital markets to make or purchase loans, by issuing pass-through securities, or by guaranteeing the liabilities of others. The GSE's included in this study had borrowed or guaranteed $768 billion by the end of fiscal year 1989, and about $850 billion by the end of the calendar year 1989.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally assisted borrowing in the form of guaranteed loans and borrowing by GSE's. Yet, as indicated in the President's budget for fiscal year 1991, off-budget borrowing under Federal auspices actually exceeded Federal borrowing to finance the budget deficits in fiscal years 1987 and 1989. Moreover, borrowing by all GSE's alone is projected to exceed Federal borrowing in fiscal year 1991.

The market's perception of Federal backing for GSE's weakens the normal relationship between the availability and cost of funds to GSE's and the risks these enterprises assume. The GSE's have the opportunity and even the incentive to seek greater rewards by taking more risk. Any benefits of this higher level of risk accrues to the shareholders of the GSE's and, to a greater or lesser extent, their targeted constituencies. The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE-guaranteed securities from loss, and providing equity investors with higher potential returns because of the greater than normal leverage some GSE's are able to assume. The asymmetry of this relationship with the Government makes it incumbent upon Con-

gress and the administration to scrutinize closely the financial stability of the GSE's and the risks associated with their activities.

Because the primary concern of the study is the financial safety and soundness of each GSE, it focuses on issues which could result in the exposure of the Government to excessive levels of risk. No effort has been made in the study to determine whether the Congressional intent of each GSE is being met. Treasury did not conduct a cost/benefit analysis to determine if the GSE's are efficiently passing the benefits of their GSE status and the resulting credit advantages through to the targeted beneficiaries—that is, housing, agriculture, and education.

President Bush, in his fiscal year 1991 budget, gave recognition to the underwriting risks associated with Government credit subsidies. He suggested that "structural reforms and better incentives for evaluating credit risks can preserve the benefits of Federal credit programs while avoiding excessive federal risk." In light of the desire of the administration and Congress to establish guidelines to improve the safety and soundness of GSE's, and as a result of our analysis of the GSE's, the Treasury proposes the following guiding principles and recommendations in order to minimize the potential risk of another costly Federal rescue:

Principle one: A GSE should be adequately capitalized, meet high credit and operational standards, and be subject to effective Government supervision; or, Congress should terminate all Government ties with the GSE.

GSE's are in an unusual position. While other corporations are able to diversify their operations, GSE's are mandated to serve specific credit needs in a single business area, which makes them particularly vulnerable to economic downturns in these areas. Furthermore, the financial risks inherent in institutions of this size pose a greater systemic risk that cannot be completely hedged or eliminated. A clear understanding of these risks and of the need to balance them against the importance of achieving desired public policy goals underscores the need to establish incentives for GSE's to operate in a safe and sound manner and with prudent and effective supervision.

Some GSE's are among the most thinly capitalized of major U.S. financial entities. Unlike other private sector corporations, GSE's are not subject to the usual market-imposed disciplines of increased costs or reduced access to capital as their balance sheet leverage increases beyond normally prudent levels. This is due to the market's perception of a unique and special relationship to the Federal Government. Market participants believe that if a GSE experiences extreme financial difficulties, Congress would step in to ensure that debt holders and investors in GSE-guaranteed securities, would experience no losses.

As a result of this market perception, GSE's are able to borrow in the market at rates higher than the Treasury itself pays, but significantly lower than AAA-rated corporations. In addition, they are able to employ much greater leverage in their activities, considerably higher than corporations that do not benefit from any special ties to the Federal Government. This ability to employ greater balance sheet leverage results in significantly higher returns to shareholders when a GSE is successful, but it can result in tremen-

dous pressure for Government assistance if a GSE encounters financial difficulty. This is similar to what happened with the Farm Credit System a few years ago, and very similar to the problems of excessive risk-taking that occurred in the thrift industry.

To correct for the bias toward excessive risk in the GSE's existing incentive structure, each GSE should be required to:

No. 1, have a significant amount of its own capital at risk so that it absorbs any losses first, and has a strong incentive to monitor and control its risks;

No. 2, meet high credit and operations standards; and

No. 3, be subject to effective Federal supervision.

If these conditions are not met by a GSE, Congress should sever the GSE's ties with the Government.

Principle two: A private market mechanism should be used to evaluate GSE risk.

While each of the GSE's was authorized by Congress for a specific public purpose and to serve a specific constituency, each operates as a private corporation with shareholders. Over the years, the GSE's have grappled with how best to reconcile the often-opposing goals of fulfilling their federally mandated public purpose and delivering the financial returns expected by shareholders.

As discussed earlier, the GSE's are not subject to all of the usual market forces that impact the activities of other corporations. The GSE's shareholders and, to some extent, the intended beneficiaries have gained from this arrangement. Shareholders have received greater returns on equity in part because GSE's have been able to operate with much greater leverage than other corporations. Targeted constituencies have also benefited because the lack of normal market restraint has allowed GSE's to expand their programs dramatically and to offer financing at reduced costs.

After careful review of the capital adequacy and other management and financial factors essential to safety and soundness, the Treasury has determined that no single capital adequacy test or standard can or should apply to all GSE's, due to the diversity and complexity of their operations. For example, forcing compliance of each GSE with risk-based capital standards for commercial banks or thrifts would not be sensible. While the amount of equity capital is an essential element of safety and soundness, it is not the only one. Other important factors need to be taken into account as well.

The private sector turns to private credit rating agencies when faced with a need to measure and monitor the risks of complex and broadly different commercial entities. These agencies are able to focus on the full range of factors that affect creditworthiness, not just capital adequacy. We believe that the approach used to evaluate or monitor risks in private markets can and should be used to evaluate GSE risks. This approach provides a superior method for evaluating risk than a reliance on a single capital adequacy standard.

Toward this end, Treasury recommends that GSE's be required to obtain a rating equivalent to triple A, absent any implicit Federal guarantee, from at least two of the nationally recognized credit rating agencies. Each GSE would be required to obtain a rating shortly after enactment of any legislation which might be enacted to incorporate these recommendations. Should a GSE be rated

below triple A, it would be required to submit and adhere to an acceptable business plan describing the actions it plans to take to achieve a triple A rating within 5 years from the date of enactment of any such legislation or lose its ties to the Federal Government.

Treasury is convinced that a triple A rating is appropriate because it represents the most safe and sound level of credit quality, and thereby the best protection from potential risk. It should be noted that requiring this high credit standard should not increase the borrowing costs of any GSE, nor would it significantly impair the ability of GSE's to fulfill their public purpose. In fact, requiring a triple A rating would only reduce the potential need for another Federal rescue.

Principle three: The program regulators should be different from the implementor of financial safety and soundness standards.

Treasury recommends that the regulatory authority which monitors the GSE's fulfillment of its Congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will minimize risks to the taxpayers by removing a perceived or actual regulatory conflict of interest. That is why FIRREA divided the thrift regulator's chartering and chief supervisor functions from its insurance function, assigning the former to the Office of Thrift Supervision, and the latter to the FDIC.

The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its congressional mandate by effectively serving its intended beneficiaries. For example, the Department of Housing and Urban Development would continue to exercise specific and general regulatory oversight over housing-related GSE's, including new program approval, and provide assurance that they meet their obligation to provide ongoing assistance to the secondary market for home mortgages for low- and moderate-income families.

The Treasury recommends that issues related to financial safety and soundness be dealt with by a different Federal entity, one that would ensure the GSE meets the requirements for a triple A-rating. In the event a GSE is not triple A rated, this entity would certify a business plan designed to achieve the required credit rating and monitor adherence to the plan.

If the business plan were not adhered to, the safety and soundness implementor would be authorized to impose sanctions that include limiting GSE growth, establishing additional financial constraints [such as dividend restrictions or reduced financial leverage], and withdrawing certain benefits of Government sponsorship [such as SEC exemption, Federal charter, use of its obligations as Federal deposit collateral, and unlimited investment in its obligations by depository institutions].

Principle four: The value of the Government's financial support should be disclosed.

The use of the credit rating agencies will provide important data for estimating the size of the implicit federal subsidy available to each GSE. For example, if a GSE were rated single-A absent a Government guarantee, the interest rate portion of the subsidy would be the difference between the interest rate at which a single-A rated corporation can borrow in the market and the interest rate

that the GSE pays. Even after each GSE attains triple A status, a significant credit subsidy not enjoyed by private-sector competitors would still remain. GSE's enjoy other financial advantages as well, but these do not all lend themselves as readily to calculation, nor is their magnitude of effect comparable.

Congress and the public should be aware of the size of the subsidy, as well as all the other advantages GSE's receive, to be better able to analyze the true costs of GSE programs compared to the benefits the targeted beneficiaries actually receive. The administration recommends the amount of subsidy that results from a GSE's enhanced borrowing status be disclosed annually as part of the President's budget.

The guiding principles and recommendations that the Treasury has proposed will assist the Government in managing its responsibility to ensure the GSE's meet their congressional mandates in a safe and sound manner. The Treasury believes that the steps outlined here will enhance safety and minimize risks to taxpayers, while maintaining the GSE's ability to efficiently and effectively serve America's special credit needs.

This concludes my prepared statement. I will be happy to answer any questions you may have.

[The complete prepared statement of Robert R. Glauber follows:]

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
May 15, 1990

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE THE SENATE BANKING COMMITTEE

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to discuss the results of Treasury's first study of Government-sponsored enterprises or GSEs.

The recent failure of many federally insured savings and loan institutions, and the massive Federal funding required to resolve the thrift problem, have focused attention on other areas in which the Government may be exposed to financial risks. In this connection, section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directs the Secretary of the Treasury to assess, in two annual studies, the financial safety and soundness of GSEs.

While we had planned to submit the study today, the need to incorporate significant new information from two of the GSEs has resulted in some delay. We will submit the first study to Congress later this month. Because our individual analysis are not available, in fairness to the GSEs, I will not comment today on the specific financial safety and soundness of the individual GSEs. Our comments in this area will, of course, be included in the full study.

Government-sponsored enterprises are entities which have been established and chartered by the Federal Government to perform specific credit functions, but are now, with one exception, entirely privately owned. GSEs generally serve as financial intermediaries to facilitate the flow of credit to private borrowers in three major areas: (1) agriculture, (2) housing, and (3) higher education. They do this by raising

funds in the capital markets to make or purchase loans, by issuing pass-through securities, or by guaranteeing the liabilities of others. The GSEs included in this study had borrowed or guaranteed $768 billion by the end of fiscal year 1989.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of guaranteed loans and borrowing by GSEs. Yet, as indicated in the President's Budget for Fiscal Year 1991, off-budget borrowing under Federal auspices actually exceeded Federal borrowing to finance the budget deficits in fiscal years 1987 and 1989. Moreover, borrowing by all GSEs alone is projected to exceed Federal borrowing in fiscal 1991.

The market's perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risks that these enterprises assume. The GSEs have the opportunity and even the incentive to seek greater rewards by taking more risk. Any benefits of this higher level of risk accrue to the stockholders of the GSEs and, to a greater or lesser extent, their targeted constituencies. The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE-guaranteed securities from loss, and providing equity investors with higher potential returns because of the greater than normal leverage some GSEs are able to assume. The asymmetry of this relationship with the Government makes it incumbent upon Congress and the Administration to scrutinize closely the financial stability of the GSEs and the risks associated with their activities.

The Treasury used a case study approach to examine each of the GSEs according to the requirements detailed under FIRREA. Each study discusses briefly the history and development of the GSE, contains a detailed analysis of its financial safety and soundness, and discusses the timeliness and quality of information that it provides to the public and the Federal Government. The analysis of each GSE's safety and soundness focused on business risk, credit risk, interest rate risk, and management and operations risk. In addition, Treasury analyzed the level of capital each GSE maintains.

Because the primary concern of the study is the financial safety and soundness of each GSE, it focuses on issues which could result in the exposure of the Government to excessive levels of risk. No effort has been made in the study to determine whether the Congressional intent of each GSE is being met. Treasury did not conduct a cost/benefit analysis to

determine if the GSEs are efficiently passing the benefits of their GSE status and the resulting credit advantages through to the targeted beneficiaries -- housing, agriculture and education.

It is important to note that Treasury did not perform an audit of any financial information or test for compliance to the GSEs' policies, procedures, or internal controls. We relied instead on the accuracy of the information presented to us by the GSEs.

President Bush, in his FY 1991 Budget, gave recognition to the underwriting risks associated with Federal credit subsidies. He suggested that "structural reforms and better incentives for evaluating credit risk can preserve the benefits of Federal credit programs while avoiding excessive Federal risk". In light of the desire of the Administration and Congress to establish guidelines to improve the safety and soundness of GSEs and as a result of our analysis of the GSEs, the Treasury proposes the following guiding principles and recommendations in order to minimize the potential risk of another costly Federal rescue.

Principle 1: A GSE Should Be Adequately Capitalized, Meet High Credit and Operational Standards, and Be Subject to Effective Government Supervision or Congress Should Terminate All Government Ties with the GSE.

GSEs are in an unusual position. While other corporations are able to diversify their operations, GSEs are mandated to serve specific credit needs in a single business area, which makes them particularly vulnerable to economic downturns in these areas. Furthermore, the financial risks inherent in institutions of this size pose a greater systemic risk that cannot be completely hedged or eliminated. A clear understanding of these risks and of the need to balance them against the importance of achieving desired public policy goals underscores the need to establish incentives for GSEs to operate in a safe and sound manner and with prudent and effective supervision.

Some GSEs are among the most thinly capitalized of major U.S. financial entities. Unlike other private sector corporations, GSEs are not subject to the usual market-imposed disciplines of increased cost or reduced access to capital as their balance sheet leverage increases beyond normally prudent levels. This is due to the market's perception of a unique and special relationship to the Federal Government. Market participants believe that, if a GSE experiences extreme financial difficulties, Congress would step in to ensure that debt holders and investors in GSE-guaranteed securities would experience no losses.

As a result of this market perception, GSEs are able to borrow in the market at rates higher than the Treasury itself pays, but significantly lower than triple-A rated corporations. In addition, they are able to employ much greater leverage in their activities; considerably higher than corporations that do not benefit from any special ties to the Federal Government. This ability to employ greater balance sheet leverage results in significantly higher returns for shareholders, when a GSE is successful, but it can result in tremendous pressure for Government assistance if a GSE encounters financial difficulty. This is similar to what happened with the Farm Credit System a few years ago and very similar to the problems of excessive risk-taking that occurred in the thrift industry.

To correct for the bias toward excessive risk in the GSEs' existing incentive structure, each GSE should be required to:

(1) have a significant amount of its own capital at risk so that it absorbs any losses first, and has a strong incentive to monitor and control its risks;

(2) meet high credit and operations standards; and

(3) be subject to effective Federal supervision.

If these conditions are not met by a GSE, Congress should sever that GSE's ties with the Government.

Principle 2: A Private Market Mechanism Should Be Used to Evaluate GSE Risk.

While each of the GSEs was authorized by Congress for a specific public purpose and to serve a specific constituency, each operates as a private corporation with shareholders. Over the years, the GSEs have grappled with how best to reconcile the often opposing goals of fulfilling their federally mandated public purpose and delivering the financial returns expected by shareholders.

As discussed earlier, the GSEs are not subject to all of the usual market forces that impact the activities of other corporations. The GSEs' shareholders and, to some extent, the intended beneficiaries have gained from this arrangement. Shareholders have received greater returns on equity in part because GSEs have been able to operate with much greater leverage than other corporations. Targeted constituencies have also benefited because the lack of normal market restraints has allowed GSEs to expand their programs dramatically and to offer financing at reduced costs.

After careful review of the capital adequacy and other management and financial factors essential to safety and soundness, the Treasury has determined that no single capital adequacy test or standard can or should apply to all GSEs, due to the diversity and complexity of their operations. For example, forcing compliance of each GSE with the risk-based capital standards for commercial banks or thrifts would not be sensible. While the amount of equity capital is an essential element of safety and soundness, it is not the only one; other important factors need to be taken into account as well.

The private sector turns to private credit rating agencies when faced with a need to measure and monitor the risks of complex and broadly different commercial entities. These agencies are able to focus on the full range of factors that affect creditworthiness, not just capital adequacy. We believe that the approach used to evaluate and monitor risks in private markets can and should be used to evaluate GSE risk. This approach provides a superior method for evaluating risk than a reliance on a single capital adequacy standard.

Toward this end, the Treasury recommends that GSEs be required to obtain a rating equivalent to triple-A, absent any implicit Government guarantee, from at least two of the nationally recognized credit rating agencies. Each GSE would be required to obtain a rating shortly after enactment of legislation incorporating these recommendations. Should a GSE be rated below triple-A, it would be required to submit, and adhere to, an acceptable business plan describing the actions it plans to take to achieve a triple-A rating within five years from the date of enactment of the legislation, or lose its ties to the Federal Government.

Treasury is convinced that a triple-A rating is appropriate because it represents the most safe and sound level of credit quality, and thereby the best protection from potential risk. It should be noted that requiring this high credit standard should not increase the borrowing costs of any GSE, nor would it significantly impair the ability of GSEs to fulfill their public purpose. In fact, requiring a triple-A rating would only reduce the potential need for another Federal rescue.

Principle 3: The Program Regulator Should Be Different from the Implementer of Financial Safety and Soundness Standards.

Treasury recommends that the regulatory authority which monitors a GSE's fulfillment of its Congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will minimize risk to the taxpayers by removing a perceived or actual regulatory conflict of interest. That is why FIRREA

divided the thrift regulator's chartering and chief supervisor functions from its insurance function, assigning the former to the Office of Thrift Supervision and the latter to the FDIC.

The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its Congressional mandate by effectively serving its intended beneficiaries. For example, the Department of Housing and Urban Development would continue to exercise specific and general regulatory oversight over housing related GSEs, including new program approval, and provide assurance that they meet their obligation to provide ongoing assistance to the secondary market for home mortgages for low- and moderate-income families.

The Treasury recommends that issues related to financial safety and soundness be dealt with by a different Federal entity, one that would ensure that the GSE meets the requirements for a triple-A rating. In the event a GSE is not rated triple-A, this entity would certify a business plan designed to achieve the required credit rating and monitor adherence to the plan.

If the business plan were not adhered to, the safety and soundness implementer would be authorized to impose sanctions that include limiting GSE growth, establishing additional financial constraints (such as dividend restrictions or reduced financial leverage), and withdrawing certain benefits of Government sponsorship (such as SEC exemption, Federal charter, use of its obligations as Federal deposit collateral, and unlimited investment in its obligations by depository institutions).

Principle 4: The Value of the Government's Financial Support Should Be Disclosed.

The use of the credit rating agencies will provide important data for estimating the size of the implicit Federal subsidy available to each GSE. For example, if a GSE were rated single-A absent a Government guarantee, the interest rate portion of the subsidy would be the difference between the interest rate at which single-A rated corporations can borrow in the market, and the interest rate the GSE pays. Even after each GSE attained triple-A status, a significant credit subsidy not enjoyed by private sector competitors would still remain. GSEs enjoy other financial advantages as well, but these do not all lend themselves as readily to calculation, nor is their magnitude of effect comparable.

Congress and the public should be aware of the size of the subsidy, as well as all the other advantages GSEs receive, to be better able to analyze the true costs of GSE programs compared to the benefits the targeted beneficiaries actually receive. The Administration recommends the amount of subsidy that results from

a GSE's enhanced borrowing status be disclosed annually as a part of the President's budget.

The guiding principles and recommendations that the Treasury has proposed will assist the Government in managing its responsibility to ensure that the GSEs meet their Congressional mandates in a safe and sound manner. The Treasury believes that the steps outlined here will enhance safety and minimize risk to taxpayers, while maintaining the GSEs' ability to efficiently and effectively serve America's special credit needs.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

o 0 o

The CHAIRMAN. Thank you. We of course have some questions we want to raise with you, but let me just say before yielding to Senator Garn and then to Senator Shelby for any opening comments that they have, that I appreciate the thoughtfulness of the presentation that has been given here today. I am interested in the ideas that you have presented.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman. Due to the delay caused by the vote, and in the interest of time, let me just ask unanimous consent that my statement be placed in the record.

The CHAIRMAN. Without objection.

STATEMENT OF SENATOR GARN

Senator GARN. Mr. Chairman, I'm very interested to hear what our witnesses from Treasury and the General Accounting Office have to say in their oral testimony today. It was certainly encouraging to read in the written testimony that none of the Government-sponsored enterprises currently is in danger of collapsing. I also completely agree that the Government must be certain that the GSE's are adequately capitalized to conduct their individual businesses in a safe and sound manner.

Having said that though, I am also very concerned that we continue to remember that these GSE's with particular benefits and ties to the Government which enable these corporations to conduct their business in the public purpose for which they were established.

Another concern I have is what may result from Treasury's proposal requiring GSE's to achieve a triple A rating. The proposal would hold Fannie Mae and Freddie Mac to a very high standard which may be difficult to meet. This requirement may have an adverse effect on the ability of GSE's to meet their programmatic missions and could have major impacts on the country's mortgage markets. On the other hand, the Government also has to be concerned with its potential liability and exposure to risks that are created by the GSE's operations. We must be sure that we strike the appropriate balance.

I look forward to hearing from the witnesses how they see public purpose balanced against safety and soundness, and their ideas about adequate capitalization.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I would ask unanimous consent that my statement be placed in the record and look forward to questioning the witness.

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I would like to commend you for scheduling this hearing and for taking a leadership role in the congressional oversight of Government-sponsored enterprises [GSE's].

While a Government guarantee is not explicit with these entities, at least the indirect or implicit suggestion of Government support is what allows these privately owned corporations to fulfill their public purpose.

I believe that, for the most part, these entities serve the public very well. Fannie Mae and Freddie Mac have created the secondary market in mortgates, thereby lowering mortgage costs to homebuyers, reducing risk to lending institutions, and introducing minimum lending standards to mortgage originators across the country.

However, the savings and loan crisis and the immense cost of making good on the Government guarantee in times of economic downturn demonstrates the importance of assessing accurately the risk to the Government and the need to ensure that this risk is minimized by adequate capital requirements, stringent underwriting rules, sufficient asset diversification, good accounting systems, and capable leadership.

FIRREA directed the Department of the Treasury and the General Accounting Office to study the riskiness of GSE's and it is to discuss these findings that we are here today. I want to commend these agencies for getting these studies in on time and I look forward to their testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Glauber, do you have any thoughts with respect to the kind of new or independent oversight mechanism, regulatory monitoring mechanism, that you make a general reference to here?

Mr. GLAUBER. Well, as I said in my statement, the general principle that we would propose is one that has grown out of our experience with the thrift industry where we concluded, and Congress agreed, that it made sense to separate the function of the overseer of the congressional mandate from the overseer of safety and soundness.

I think that principle is going to work well in the thrift industry and it would work well here. There are a number of candidates for the role of implementor of the Federal safety and soundness requirements. The Federal Reserve System would be one. The FDIC would be an obvious second choice. Other alternatives would perhaps include the Treasury.

The CHAIRMAN. Have you given any thought to possibly a freestanding regulatory body that might look after all of these together?

Mr. GLAUBER. That would be, of course, another alternative. I think this task, while very important, might not be one of such magnitude as to merit an entirely new agency, and that it could be incorporated into the workload of one existing agency.

The CHAIRMAN. When you mentioned that the amount of borrowing for the current projected fiscal year exceeds that of all other, or the size of the deficit borrowing that the Government generally will take on, can you break that down by component parts?

Mr. GLAUBER. Well, in calendar year 1989 out of a total borrowing in the private markets of about $935 billion, Treasury borrowed about $150 billion. By coincidence, the GSEs, plus Ginnie Mae and the agencies, borrowed an equal amount of $150 billion. So it happens in 1989 that the load was just equal, and we expect in fiscal 1991 the borrowing load of just the GSE's alone will exceed Treasury.

The CHAIRMAN. Now with reference to that point of the size of the amount of borrowing that's being done here, have you had a

chance to think about or assess what the overall effect on the economy might be? We all tend to look at these agencies one by one, but I am wondering in thinking about the implications of these combined activities, do you have a view as to whether they have an appreciable effect on Treasury borrowing costs generally, or on the interest rates that are paid by borrowers outside these programs?

Mr. GLAUBER. It turns out that this is a very difficult question to evaluate. It is a fact that the GSE's have been the most rapidly growing borrowers in the market. Their borrowing has grown almost 20 percent a year during the 1980's, much greater than the Federal Government's direct borrowing.

At the same time, when one tries to measure the impact of the GSE's borrowings compared to the Treasury's, it statistically turns out to be a very difficult process. The reality is that, due presumably to other macroeconomic factors, the cost of borrowing for the Government has declined pretty steadily throughout the 1980's. Therefore, it is very difficult for us, or others who have tried, to find a statistical relationship that suggests in what manner the GSE's borrowing has affected the cost of Treasury borrowing.

I agree with those who have suggested that from simply looking at the numbers and seeing that the GSE's borrow nearly as much now as the Treasury, that one would expect there to be some impact. But, I have to report to you that any studies that we have pursued have been unable to quantify that impact.

The CHAIRMAN. Now about any appreciable risk, do you—having looked at this and having had your people look at it—do you see any areas out there where you identify an appreciable risk of a problem coming down the road at us that we ought to be thinking about and ought to be red-flagged here today?

Mr. GLAUBER. Well, first I would state that we see none of the GSE's in eminent danger of causing trouble for the Federal Government or the taxpayers. On the other hand, when you have these entities operating in an environment where the private markets do not impose discipline, since the markets assume that they are federally guaranteed, it is possible for them to increase their leverage beyond the bounds that a private entity would. Indeed, several of them operate at levels in which their capital-to-assets ratios are below 1 percent. That, in principle, could pose a danger in the future. We have seen it happen in the thrift industry and in the Farm Credit System in the late 1980's.

The CHAIRMAN. Can you take us any further with respect to any example that would give you a greater sense of apprehension or concern?

Mr. GLAUBER. Well, I think at this stage, Mr. Chairman, I would like to withhold comments about the specific GSE's until our full report is available to you and to the public, rather than to get into it now.

I think it is fair to say that some of these GSE's operate at levels that the public or private market rating agencies would rate below investment grade, as you pointed out in your opening statement, and as I believe you heard in testimony before this committee late last year.

The CHAIRMAN. Do you envision coming back to us with a formal proposal say this year?

Mr. GLAUBER. No decision has been made about the submission of legislation, but we would be very happy to talk with you and your committee about that issue.

The CHAIRMAN. And does that apply also to next year? I did not mean to just limit that to the remainder of this legislative year. But I am wondering if internally you have set a goal for yourselves as to try to prepare with others a legislative package, or is that still unclear?

Mr. GLAUBER. That is under discussion. No decision has been made. We would like to pursue those discussions.

The CHAIRMAN. Very good.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

In your proposal to require GSE's to obtain triple A ratings, I am really very concerned about that and how we achieve it. I guess the number one question I would ask is: Considering that they do have, the GSE's all have governmental ties. How can the rating agency be blind to that fact? How can they rate them objectively, as they would a private enterprise, when everybody knows of the ties to the Government?

Mr. GLAUBER. I think that is a very fair question and one we felt obligated to explore with the rating agencies before we put this proposal forward. In our informal discussions with them, they have indicated to us that they feel themselves quite prepared to make that rating absent any Federal Government guarantee; that they could perform and perform in their view, quite, straightforwardly. [That kind of mind experiment, if you want to call it that].

Senator GARN. Well, in their view, but it seems to me to sort of suspend reality to think that they can really objectively divorce that from their analysis.

Mr. GLAUBER. Well, Senator Garn, they, as you know, as a routine matter rate private entities which span the spectrum of activities and capital structures. This is what they are set up in business to do. I think the way they would perform such a rating is to go in and look at all the factors they normally look at, absent the possibility of an implicit Government guarantee and provide a rating. It is their view that they could do this and do it quite adequately.

Senator GARN. Should we expect that you will be proposing legislation that requires this?

Mr. GLAUBER. As I said to the Chairman, no decision about specific legislative moves has been made, but it is something we would be perfectly prepared to discuss.

Senator GARN. In your studies of GSE's at Treasury, did your analysts examine the studies of Freddie Mac and Fannie Mae which were performed by Price Waterhouse and James Wolfenson?

Mr. GLAUBER. Indeed, we have looked at those studies, as well as others.

Senator GARN. Do you believe that those studies were flawed?

Mr. GLAUBER. Well, to take, for example, the Wolfenson study, we concur in what I take to be a major conclusion of that study, which was that the bank capital standards, thrift or commercial bank capital standards, really are not applicable to GSE's. We agree with the suggestion in that study that a single standard like this really would not be the right way to approach safety and

soundness for institutions as diverse and complex as the GSE's, and indeed that was one of the motivations for the proposal we have put before you today.

Senator GARN. Beyond the issue of whether they can objectively rate, I am sure you are aware that only one commercial bank has achieved this standard of having triple A from two different rating agencies? And certainly I know of no thrift who could possibly achieve that.

Mr. GLAUBER. Well, I appreciate that. Our suggestion that triple A rating is the appropriate standard arises from the fact that these institutions have an implicit Government guarantee behind them and that we think the taxpayers should be exposed to as reasonably small an amount of risk as possible. It would be possible to have other standards, but, of course, that would expose the taxpayers to a higher level of risk.

Senator GARN. I do not disagree with what you are trying to achieve. I am just trying to point out that you are asking, first of all, for rating agencies to try and divorce all this from their mind in rating. And then second, you are asking for a standard that only one commercial bank in the entire United States has. Are we dealing with reality? We are not dealing with rhetoric of whether we want to minimize the taxpayers' risk. There is no one in this town that is going to answer anything else but that they want to do that, if for no other reason than you have got to be on the side of motherhood.

But while we are trying to achieve that, are we asking for a standard that is not realistic to achieve when one commercial bank has achieved it, and they have obviously FDIC insurance, access to the Federal payment system, low-cost borrowing advantages, and all of that; and with all those advantages, one bank has achieved it.

My basic line of questioning is: Is this an unrealistic standard in light of the facts that I have given you?

Mr. GLAUBER. I do not think it necessarily is, Senator Garn. The GSE's also have some very real advantages. They have, in the case of Fannie Mae and Freddie Mac, a nationally diversified portfolio. They have access to the capital markets in a manner in which most commercial banks do not. So, I think it is not unreasonable to suggest this as a standard. What would be required, of course, is that in most cases they raise more capital either through retentions or through selling more equity, but it could be done. There are some GSE's right now that I believe would achieve a triple A rating as they stand today. Sallie Mae would be one of them. I believe such a statement was made in testimony by S&P before this committee last year. So, I do not think it is beyond the realm of possibility at all. Indeed, as I say, it has been achieved by Sallie Mae, and I believe Connie Lee would also be rated as triple A.

Senator GARN. Well again I just hope we are not setting up a standard that is so difficult to achieve that we have not solved the purpose of minimizing the risk to the taxpayer and upset the capital markets in doing so. Sometimes you can accomplish a purpose with a lesser standard, and you reach a point of diminishing returns.

I read a story the other day in the New England Journal of Medicine how running up to 25 miles a week improves your health.

Beyond 25 miles a week, the point of diminishing returns goes the other way. And that is my basic question. Are we reaching that point of diminishing returns if we set up a standard that is so difficult to achieve that we do not help solve the problem.

Mr. GLAUBER. I myself do not run any risk of getting to the point of diminishing returns on what you suggested, but——[Laughter.]

Senator GARN. Well, I used to, but after reading that study I have cut back to 25 miles a week. [Laughter.]

Mr. GLAUBER. I accept the tenor of what you are saying that this is necessarily a tradeoff. I believe that this is a balanced tradeoff. Others might well disagree, but I think it is both an achievable and appropriately balanced tradeoff.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I just want to pick up on what Senator Garn was questioning you about. On page 5 of your testimony I believe it says, toward the bottom, "It should be noted that requiring this high credit standard should not increase the borrowing costs of any GSE, . .". Of course that is a hopeful statement, the way I read it there. Am I right on that? "Should not"?

Mr. GLAUBER. Well, they borrow today as if they were Government guaranteed at rates better than triple A rated corporations, and presumably having them upgrade their capital structure would not increase their borrowing costs. What it would require in some cases, but not all, is adding some capital, as well as developing probably some better management techniques and management information systems.

Senator SHELBY. Of course they were created—most of the GSE's, I suppose all of them were created with a public purpose in mind such as Fannie Mae, Freddie Mac, Sallie Mae, and so forth, and with the growth in the secondary home market, would you agree that they have served a tremendously valuable public purpose?

Mr. GLAUBER. Absolutely.

Senator SHELBY. And will this intensify in view of the problems in the thrift industry and the need to have a secondary market for homeowners in America?

Mr. GLAUBER. I believe they have served an important purpose and will continue to serve that purpose. I don't believe that this recommendation that they establish this level of safety and soundness would get in the way of that public purpose.

Senator SHELBY. Where would they get additional capital? I know the capital markets are all—you are trying to go there from time to time to get money for the savings and loan bailout——

Mr. GLAUBER. As we talk.

Senator SHELBY [continuing]. Probably right now——

Mr. GLAUBER. Right.

Senator SHELBY [continuing]. Right at the moment. Would this defeat their purpose? Or would it augment both the savings factor of concern—I mean, saving our money and not bailing out anybody in the future—how would it impact on anything that they are doing?

Let us assume that what they are doing looks good. We like what Fannie Mae is doing. We like what Freddie Mac is doing. We like what Sallie Mae is doing.

What is the down side?

Mr. GLAUBER. Well, let's take, since you raised it as the first one, Fannie Mae. I presume that Fannie Mae would add capital from two sources.

Senator SHELBY. OK.

Mr. GLAUBER. One would be retentions, and the other would be the sale of new equity. Fannie Mae last year made $800 million, so it has a large pool of earnings that it could retain. It also might choose to sell some equity.

Senator SHELBY. Would you say they are well managed?

Mr. GLAUBER. I think Fannie Mae is well managed. We have identified some weaknesses that we would recommend it direct attention to, but I think overall——

Senator SHELBY. Overall, they are well managed.

Mr. GLAUBER. They are well managed, and——

Senator SHELBY. What about Freddie Mac?

Mr. GLAUBER. I would say exactly the same. Just to return to Fannie Mae, its management has brought it along from a position of considerably less safety and soundness to a much higher one today, so one has to give management very high marks. I think that it would be possible for Fannie Mae to accumulate more capital, both from retentions and the sale of new equity. Its stock currently sells at roughly three times book value. It does so, in part, because Fannie Mae's return on equity is roughly 30 percent. Even if Fannie Mae were to raise more equity, it would still have a very high return on equity and a very good market, I would think, for its common stock. So, it could retain more profits and could raise equity by the sale of stock. Both sources would be available to them. I do not think raising more capital would require that Fannie Mae restrain its service to its beneficiaries and its congressional mandate.

Senator SHELBY. Let us get back to the GSE's basically. When they were created, did we have a legal obligation? Or is it mainly a perception in the marketplace that they are a Government enterprise, they are Government-backed, that the Congress and the President are going to step in if they get in trouble?

Mr. GLAUBER. It is a perception.

Senator SHELBY. But it is not legal, is it?

Mr. GLAUBER. The Secretary of the Treasury may, at his discretion, purchase a certain amount of GSE securities—it differs from GSE to GSE. There are, of course, a number of ties between the Government and these entities. They have a Federal charter. They are, for the most part, exempt from SEC registration. They are exempt from State and local taxes. So, there are a number of ties that bind them and the market's conclusion from all of this, pretty clearly, is that the Government would step in if there were a problem. The Government did step in in the Farm Credit System and, of course, as a result they tend to trade at rates slightly higher than, but not much higher than the Government's own paper.

Senator SHELBY. But it goes back to why we created them for a public purpose, and a mandate there that for the most part that they are serving in America. Is that right?

Mr. GLAUBER. I agree with that, Senator Shelby. I do not think that the proposal that we upgrade their safety and soundness and put into place a mechanism to assure it would get in the way of that mandate.

Senator SHELBY. You do not see any contradiction there, do you?

Mr. GLAUBER. I obviously see in all of these situations some tension, but I do not think it needs to get in the way of their serving their congressional mandate.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Well, Mr. Glauber, let me first say that I agree with you on this issue. I guess one of my concerns—well, I really have two concerns.

One is that Congress is often driven by the desire to address a problem, whether that problem is farm credit, or housing credit, it is driven by a great noble objective which of course is re-election, and also to serve the public interest—the two being the same in some cases, and not in others.

But basically the problem as I see it is two-fold. One, the lack of a market check on what we are doing. For example, I did not follow exactly what was happening in the credit market related the Farm Credit System, but had we had any kind of market check we would have picked up the problem far earlier. Had, for example, in the extreme case we decided that we wanted to know how much this program was costing, so we were simply going to market the paper we got, sell it on the open market and take our loss and call that the subsidy, we would have immediately recognized that there was a huge risk of default out there because the paper would have started to trade at a very heavy discount. The level of subsidies would have started to skyrocket, and we would have been awakened in the Congress.

As it was, while I do not know what happened to the interest rate being paid, but by and large there was no market response because of a belief that the Government was going to pick up the check, which of course it did.

We have similar problems related to housing in my part of the country. Our down payments are often so low on Federal guarantees that the first thing people do when they run into trouble is they walk off and leave the house. It makes us the happy owner of that house, and sets in huge losses, and yet if we had some kind of market mechanism, if we had them rated in terms of the credit worthiness of their operation, how strong their portfolio was, we would pick up early warning signals.

In this case, the only signal we got is when we actually lost money under many of these guarantee programs.

So there are two things I would like to see happen. I think they are going to be very difficult to do politically because I think Congress is going to be basically hostile to them, but I think that, one, we need a full accounting on a continuing basis of what our exposure is under what I would call "contingency liability." What do we have to pay if other people do not pay?

I think it would be helpful also if we had an ongoing assessment of their ability to pay and the value of the assets that are committed so that we have not only the contingency liability, but we have some kind of measure of how pressing that contingency might be.

I think the second thing, if we set some credit-worthiness standards that were set out in law where the private financial market assessed these agencies and they could not operate unless they met them, then in a sense we would put in an automatic monitor which I think would be more reliable than the Congress. And, while it is easy for us to say, well, let us just not worry about the problem; it will go away. If for example suddenly FHA were told that you are about to lose your rating and that is going to limit your ability to issue new guarantees, and you have got to make these changes to do it, and they had to make the choice in order to meet the requirement, I think you would substantially change the system.

Let me sort of get your response to those two concerns and how your proposal deals with each of them.

Mr. GLAUBER. Well, to take the second one first, we quite completely agree that what we need is some kind of monitoring mechanism. Our preference for that monitoring mechanism is to look to the private markets and see how they do this. These institutions are complicated. They differ one from another. We despair of any simple kind of capital adequacy measure, or single measure, applying to all of them, and we despair of having that measure applied, quite frankly, by Government bureaucrats. We think that we ought to look to the private markets to see what they do when faced with this kind of complexity. What they do is turn to rating agencies. That is where we would like to turn. So we quite agree with your suggestion, and indeed that is embodied in what we have proposed.

Mr. GLAUBER. As regards the amount of Government exposure again, I think full disclosure is a very useful way of keeping people's eyes focused on the problem. We again embody a formal disclosure in what we have proposed.

Senator GRAMM. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Mr. Chairman, I pass at this time.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Chairman, I ask unanimous consent that my opening statement be placed in the record at the appropriate point.

The CHAIRMAN. Without objection.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I join you welcoming Undersecretary Glauber and Assistant Comptroller General Fogel to our committee as we examine the operations and financial condition of Government-sponsored enterprises—so called GSE's.

Although this hearing follows Mother's Day, Father's Day, may have been more appropriate since GSE's are in many respects Uncle Sam's favorite offspring. Not only did we name them Fannie, Freddie, Connie, and Sallie, but we also gave them many benefits that only a governmental parent could provide, including lines of credit at the Treasury Department and various exemptions from

securities and tax laws. We also instilled within them strong values to serve the public interest through the financing of housing, education, or farming. By most accounts, GSE's have done a good job to make Uncle Sam proud.

GSE's are raised to be financially independent. They do not receive a Government allowance. Nonetheless, with over $700 billion of debt outstanding, some observers feel that GSE's may be getting too big for their britches. Others fear that at the first sign of financial trouble, GSE's will be writing home for money. Investors and creditors believe that Uncle Sam will not turn them away.

Mr. Chairman, I am pleased that our GSE's have left the nest. However, we should make sure that they don't have any financial problems that will come home to roost. Since GSE's are all in family, I will be interested in our witnesses' advice on how best to exercise parental supervision.

Mr. Glauber, there is a time-honored nostrum here which is that "if it ain't broke, don't fix it."

You have said in response to questions today and, indeed, in reading your testimony, your testimony could lead one to conclude that, by and large, the Government-sponsored enterprises that we have been talking about are doing a good job. They have adjusted to the changing markets of the late 1970's and 1980's. They have done so without catastrophe or crisis. Indeed, they seem to be fulfilling, some to perhaps a greater extent than others, their originally intended purpose, which, generally speaking, is the allocation of capital to provide liquidity for what Congress views as a socially-beneficial purpose, such housing, student, education, and so forth.

You are saying, as far as I can tell, that, something might go wrong in the future. You suggest some GSE's are thinly capitalized. You say that there could be Government exposure. My question to you, looking at the record, is how real are those fears?

Mr. GLAUBER. Looking at the record, the fears are quite realistic. To say, "it ain't broke" is to run in the face of experience. A couple of parts of this have become broke. The Farm Credit System was broke and had to be bailed out. A related side of enterprises, that is, the deposit insurance and the thrifts, got broke and you spent most of last year helping them out. I think the evidence is that this system can break down. Furthermore, I think the time to try to fix something is when it is not entirely broke.

If we put this kind of phased process in place, it would be possible for the GSE's to build their capital to the point that we recommend and to do it in an orderly way. Furthermore, what would be put into place is a system of supervision which would keep them adhering to these high levels of safety and soundness.

I think, first, there is evidence that they were broke. While none of them is in imminent danger today, they have forces at work which could lead them back there again. And I think now is a very good time for us to act on it and to act on it in the cool light of day, and to do it carefully and correctly.

Senator HEINZ. You mentioned FSLIC and the Farm Credit System. There are some very fundamental differences between those systems and these enterprises. They were, in fact, called systems for a very good reason. They were not privately traded corporations, as these are.

They underwrote the activities of specific groups of institutions, which these enterprises do not do. And these enterprises, in effect, operate largely in secondary market activities. The differences, it seems to me, with the FSLIC and the Farm Credit System are, frankly, such that I don't see how you could use those as good indicators.

But, if you wanted to use something as an indicator, one might say look at the Federal Government. It's broke. It has a lot of debt. You work for the Treasury Department and you are our financier and accountant.

So, be careful about calling the kettle black.

Mr. GLAUBER. Let me make one point. The Farm Credit System, I think, is clearly a GSE. And I think it really does fall within the range of the ones that we are talking about. I agree with you that there may be some differences to FSLIC, and GSE's although with both there are, indeed, some of the same kinds of problems where you have relatively little capital at risk ahead of any implicit or explicit Government guarantee. So, I think it is fair to include them broadly together.

Senator HEINZ. One of the arguments about leaving the system pretty much in tact is that there are certain market indicators of financial condition. The price of the stock of Fannie Mae, for example, is useful. Another indicator is the price of the credit that is sought in the market by these institutions.

Also the benefits are, of course, for a congressionally mandated purpose.

I note that, in your testimony, you say you didn't perform a cost benefit analysis. My view is that it would be extremely helpful to all of us who want to be sure that we understand that these enterprises are meeting their intended purpose and are doing so in a way where the benefits that are conferred upon them by virtue of the lower cost of funds, which they get from the kind of association they have, are, in fact, being well- applied.

Do you anticipate you will be able to provide us with a cost benefit analysis? Or is that beyond the scope of what you think you can achieve?

Mr. GLAUBER. That was explicitly beyond the scope of what we were asked to do. I think it is obviously a very difficult task, although a very important one. What makes it difficult, in part, is that the benefits that are obtained from the enhanced borrowing status of these institutions fall both to their congressionally mandated beneficiaries and also to the stockholders.

Separating those benefits out is sometimes difficult as well. So, I can tell you that it will not be in the report we submit. We were not asked to do it. We do as we are told.

Senator HEINZ. Congratulations. My time is expired.

Senator GRAHAM. Thank you, Senator.

A recent Wall Street Journal article, by Mr. William Gale, Assistant Economics Professor at UCLA, made some suggestions for improvement in Government-Sponsored Enterprises, three specifically.

One was to increase capital requirements of the GSE's.

Two, the GSE's should pay risk-adjusted fees to the Government based on the amount of their indebtedness.

And, three, that there should be more informed and consistent regulation of GSEs.

I wonder if you could comment on those three recommendations.

Mr. GLAUBER. Well, again, I think the comments would vary from GSE to GSE. But, for some of them at least we believe that they should increase their amount of capital. To take as an example, Fannie Mae, Fannie Mae has stated itself that it believes that it should and is in the process of doing that. I would just point out that capital and capital adequacy is but one of the factors which contribute to safety and soundness.

Senator GRAHAM. Do you believe on that specific point that there is some minimum capital that should be required of all GSE's analogous to the minimum capital which is required of insured thrifts?

Mr. GLAUBER. We would prefer the mechanism we propose, which is to look to the private rating agencies, and the reason is that GSE's are such complex institutions and capital adequacy is but one dimension.

Senator GRAHAM. The answer to the question is you do not think that there is any absolute minimum capital that should be required as a precondition?

Mr. GLAUBER. I assume the rating agencies would, in fact, require some amount of capital. But we would look to their mechanism in establishing what we recommend a triple A rating.

Senator GRAHAM. But you would not recommend any Government-imposed minimum capital that would be generally applicable?

Mr. GLAUBER. We certainly wouldn't recommend the use of commercial bank or thrift capital adequacy standards, or something like that. Correct.

As regards the other two points, we certainly think enhanced supervision is important. As it stands now, there are several GSE's that have no Federal supervision—Connie Lee and Sallie Mae. Furthermore, as outlined in more detail in my statement, we think it would be useful to have a separate Federal implementer of the safety and soundness standards, separate from the Federal body responsible for overseeing whether these GSE's meet their congressional mandate for reasons that, I think are pretty clear from the thrift experience.

Senator GRAHAM. On the issue of supervision, the Treasury has statutory authority to approve or prohibit new issues by new GSE's. I understand that has been used primarily as a gatekeeper function in order to see that the market is not flooded or disrupted.

It has been suggested that Treasury could take a broader view of that statutory authority. For example, to stop issues by GSE's which it judges to be under-capitalized or operating in an unsafe manner.

What is your interpretation of your statutory authority? And what is your policy basis as to how to utilize it?

Mr. GLAUBER. The statutes are somewhat ambiguous. We have looked at the legislative history and our attorneys' conclusion is that the legislative history points mainly in two directions. One, is as you have suggested, the coordination of Federal borrowing, that is to act as what we often call a "traffic cop." The second, to the extent that there is approval or disapproval power, really goes to

particular types of securities, rather than looking at the capital structure and safety and soundness of the institutions. So it is our view that we do not have the mandate from Congress to act as a safety and soundness regulator.

Senator GRAHAM. Do you have a recommendation as to whether that authority should be granted to the Treasury?

Mr. GLAUBER. We have a recommendation that there should be a Federal implement of safety and soundness provisions. We left open who that might be. As suggested earlier, there are a number of candidates. The Fed would be one candidate. The FDIC would clearly be another candidate. From our recent experience, the Treasury clearly could be a candidate, as well.

Senator GRAHAM. You do not have a recommendation as to which of those candidates you think would be preferred?

Mr. GLAUBER. That's correct, we do not.

Senator GRAHAM. What about the third issue of requiring risk-based fees to be paid to the Government?

Mr. GLAUBER. The administration has looked at the issue of fees and, indeed, a proposal of fees is incorporated in the administration's budget for this year. It is not a risk-based proposal. That is something that could be investigated further.

Senator GRAHAM. One issue that is coming up now as it relates to the RTC and could be applicable to other Government-sponsored enterprises if they were to get into a similar liquidation situation is how working capital should be provided and the how it should be treated, first, for on budget/off budget purposes and then on Gramm-Rudman/off Gramm-Rudman.

I would be interested in your thoughts on those issues.

Mr. GLAUBER. Working capital poses a real problem for budgetary score-keeping because it is, by definition, a temporary expenditure. Private corporations, when faced with temporary expenditures for working capital, do not allow those to hit the bottom line to affect earnings.

I think that there is an argument on the side of suggesting that it should not be included in the budgetary treatment. The argument would be as much the way it would distort the budget when the money comes back as how it distorts it when it goes out. There would be a large budget deficit number when the money was spent. But, when those assets are sold and the money is returned to the RTC, there is a surplus which would be a phantom surplus, just offsetting the deficit of an earlier year. That could be very distorting for the process. So, I think there are good arguments to suggest that it should be excluded.

Senator GRAHAM. Would Treasury have some generic recommendation to make on capital, working capital that could be applied immediately to RTC and then be looked to as the need may arise in other GSE's?

Mr. GLAUBER. Treasury at this stage has no specific recommendation. But I know that these have been issues that have been discussed in the Budget Committee and are likely to continue to be discussed.

Senator GRAHAM. I would encourage the Treasury to give some thoughtful attention to this issue so that it is handled as a general

policy, not one that becomes politicized to meet the immediate convenience of a specific circumstance.

Mr. GLAUBER. I understand what you're saying.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Let me cover one other thing.

Senator Bond, were you able to question earlier?

Senator BOND. Not yet.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you, Mr. Chairman. I want to make a couple of observations first. I want to commend you and the ranking member for holding the hearing. I appreciate Secretary Glauber's remarks because, as he said, we may be considering this in the cool light of day. But I hear the ominous rumble of the artillery being pulled up on the other side of the hill.

And I think the cool light of day may not last very long. I feel that we ought to be exploring this. I think, and, again, I would agree with Secretary Glauber, that when you talk about a cost benefit ratio, we have generally made the decisions when we have authorized these GSE's as to the benefits.

I would suggest, and I assume that you would agree, Bob, that for any of these GSE's which have such a high social value that they would not otherwise meet the capital and operating standards, that that ought to be covered by a direct subsidy appropriated by Congress rather than in any way relaxing the standards by which the paper of the GSE would be evaluated.

Is that fair?

Mr. GLAUBER. I think that would be a reasonable approach.

Senator BOND. Also with respect to the decision on who should regulate these, I know that the Treasury does many things very well. But, would this function be more appropriately lodged in the FDIC really as one better able to regulate the risk-taking? Or, if you prefer not to make a judgment, I will leave that as a suggestion of mine.

Mr. GLAUBER. I would say that FDIC would be a very strong candidate. It certainly falls within the domain of what they are used to doing.

Senator BOND. I don't understand economics well enough to figure out how the proposal that you have on page three and four would work. You say that if the GSE does not—is not adequately capitalized to meet high credit and operational standards, then Congress should terminate all Government ties with the GSE.

About the time that happens, it goes flat. Right? It is dead meat when that happens.

Mr. GLAUBER. I'm not sure I would quite characterize it that graphically. The point is this. This proposal would give the GSE's ample time—in our proposal, 5 years—for a phased plan that would bring them to meet the standards. During that period, they would come under the watchful eye of the Federal implement of the standards.

So, I don't think that we need to overly concern ourselves about what would happen. I think that they could meet the standard. As I said, some of them already do.

But, the incentive to meet the standard would be that, if they don't meet it, the Government in that case would push these insti-

tutions away and say we do not want to underwrite or guarantee their debt.

Senator BOND. I certainly don't have a better solution on the top of my mind to share with you today. But the thought occurred to me, when I first read this about terminating all Government ties with the GSE, the impact of that action I think would be disastrous, whatever you call it.

The prospect of that might even be in my thought to expose all of these GSE's to greater risk and perhaps require higher interest payments if people thought that we had a Government umbrella over them only when it was a sunny day, and if the storm clouds came on the horizon, the Government would take the umbrellas back.

Is that likely to happen—initial, adverse impact that would distort or limit the viability of these GSE's to participate in the marketplace?

Mr. GLAUBER. I don't believe so. I think what would be asked of them is that they build capital over time. And I don't think that charging more for the umbrella, if that is what you want to call it, would be something that would cause the market to be frightened. These GSE's, I believe, could, during this period that is being proposed, build that capital.

As I pointed out a little earlier, take just as an example, Fannie Mae. It earns a great deal of money and it has access to the equity markets on very attractive terms, three times book value. So that it could build up capital and it wouldn't have to do it in a day. It could do it over 5 years. Again, Fannie Mae has explicitly recognized the need to add capital and has proposals that will add $2 billion in capital. I don't think this is the kind of proposal that would jeopardize them at all, but it would add a layer of safety and soundness, a layer of protection, so that we wouldn't revisit what we have experienced in some other settings.

Senator BOND. There is, I sense, in the halls around here always some thought that perhaps another new activity could be assisted by the establishment of a new GSE. I would gather that you would recommend that, in establishing such, we include such standards and such operating guidelines, capital standards.

Are we in a position where, collectively, the number of GSE's we've already established are having an effect on the interest rates that are paid for out of Government borrowing? Are we getting into a problem where we have done too much?

Mr. GLAUBER. It is a very reasonable question, and I cannot give you as good an answer as I would like. Just as a layman, if one came upon the fact that the GSE's are as active in the capital markets as the Government itself directly, you would expect there would be some impact. The problem is that when we do any kind of statistical studies over the last 10 years, it is very hard to discern that impact.

I think one of the main reasons is that the macroeconomic factors that have seen our interest rates fall, in the case of the prime rate, 20 percent, down to 10 percent or lower, those macroeconomic factors, I think, have overwhelmed any attempt that we have to distinguish the impact of GSE's on Federal Government borrowing.

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As I say, I think just common sense would say that there should be some impact, but I cannot report to you that statistical studies by us or others have been able to quantify that impact.

Senator BOND. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

The CHAIRMAN. I want to ask one question, and then Senator Heinz has a question. Let me be sure you have had a question round?

Senator HEINZ. Yes.

The CHAIRMAN. A different subject, an important one: the FIRREA legislation. I think you were probably as instrumental in designing that legislative package as anybody in the Treasury Department or in the legislative or executive branch.

We spent many long weeks and months working it through early last year. Some people are suggesting that there are some things that need to be adjusted in the legislation, that the time may be here to revisit the legislation this year and make modifications to it. I am wondering what your view is on that. Do you think that the bill ought to be opened up this year?

Mr. GLAUBER. We would prefer to see it work for a while before it is open.

The CHAIRMAN. Then, the administration has no specific recommendation with respect to changes in the package?

Mr. GLAUBER. At this time, that is correct.

The CHAIRMAN. It is your view generally, the package seems to be working more or less as you intended? Are you reasonably satisfied with it? I know that there have been some problems with respect to getting all of the slots filled and so forth. But, with respect to the mechanics of the legislation itself, is it working more or less as you anticipated?

Mr. GLAUBER. I think there have been some things that have been perhaps unanticipated. But we think that it is a framework that can be made to operate and operate effectively. And we would prefer to operate within its framework.

The CHAIRMAN. And with respect to the cost projections, how are we doing in that respect?

Mr. GLAUBER. I think that we are in the process of further developing those cost projections. I think it has been said on several occasions it is pretty clear that the costs will exceed the $50 billion for the period of 1989–92 that was embodied in the original legislation. That estimate, as you know, was made by a number of people—FDIC, the Home Loan Bank System, GAO, and it now appears, as we have gotten inside those institutions and as we have seen the unwinding of various economic factors, that the costs are going to be higher. We are trying to refine those estimates. I think we should have more to say to you when Secretary Brady appears in another week.

The CHAIRMAN. We are looking forward to that oversight hearing. We will have the principal participants of the Oversight Board here that day. We would hope that we would get an updated assessment of what the financial implications seem to be.

Mr. GLAUBER. I might add, Mr. Chairman, the problem will continue as it did before. All of these estimates will be subject to tremendous uncertainty. We do know more about these institutions

now as we have gotten inside of them and actually looked at them. But, on the other hand, the same kind of economic factors that have influenced the costs so far will continue to influence them, and I fear that we will never have a perfectly refined estimate of what this is going to cost. What I can say to you is that, so far, there certainly has been enough money available to do the job; of the $50 billion, the RTC has only spent something in excess of $10 billion.

The CHAIRMAN. Somewhat in excess of $10 billion.

Mr. GLAUBER. It has of course spent more than that, including money for working capital. But, if you just take the money available to make up losses for which the $50 billion was set aside, something in excess, but not greatly in excess, of $10 billion has been spent.

So I don't think that the availability of funds has stood in any way in the way of the RTC doing its job. And, again, it will always be an uncertain estimate of just what it will cost.

The CHAIRMAN. Very good. Before we go on, I have a statement from Senator Dixon for insertion in the record and then we will go to Senator Héinz.

STATEMENT OF SENATOR ALAN J. DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee considers the reports of both the Department of the Treasury and the General Accounting Office [GAO] on Government-Sponsored Enterprises [GSE's]. These reports were both mandated by the Financial Institutions Reform, Recovery, and Enforcement Act [FIRREA] passed last summer. For the record, I want to be clear that I voted against FIRREA for reasons completely unrelated to the provisions requiring these two reports. I am pleased that these reports were mandated because oversight over the GSE's is vitally important.

In view of the enormity of the Federal Government's responsibilities to protect depositors in our Nation's failing savings and loans, it is not only appropriate that we review carefully the Federal Government's indirect commitmenmts in other areas; it is imperative that we do so.

I commend Chairman Riegle for his attention to oversight over this matter. I look forward to the testimony of Treasury Under Secretary Robert Glauber and Assistant Comptroller General, Richard Fogel.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Bob, just one question on your proposal which, in some respects, if we were to implement it today would not necessarily change the way that any of these agencies operate; although there would be the usual argument over who should be the regulator and what would be an objective regulator.

Let me ask you this. You proposed that the assessment of the credit-worthiness of these organizations be done by Moody's and Standard and Poor's, which are private sector risk assessment organizations.

Why couldn't the same risk assessment be done by the Federal Government? Is it that we lack the know-how and skills? And if we do lack the know-how and skills, why do we have the FDIC and others doing their jobs?

Should we privatize the FDIC?

Mr. GLAUBER. I think the reason we propose it is that these institutions are in many ways very different from banks. We have built a tremendous amount of experience dealing with banks. We have a big regulatory staff, a big examination-supervision staff, doing those, and I think that the Federal Government has built a tremendous capability in doing that. These institutions really are different from banks. They are diverse. They are complex in ways that banks aren't. They have access to the capital markets in ways that many banks don't. So, the task of trying to monitor and measure their riskiness is, in many ways, more difficult.

The private rating agencies were developed by the private sector to do just this. That is the one function that they do. They are like a greyhound that only runs fast after rabbits. These people just simply spend their time rating complex institutions. We think, faced with the complexity and diversity of these institutions, that it is an effective way to deal with the problem. I don't think that it in any sense need cast criticism on the ability of the bank regulators and thrift regulators to do their job. They really are different jobs.

Senator HEINZ. Maybe I'm missing something, but compared to a bank which is operating in many markets these days, with the enormously different types of products today than they had 10 or even 5 years ago, I am at a loss to understand why a Sallie Mae or a Freddie Mac, or a Fannie Mae, which, basically, underwrites in the secondary market a variety of, more or less, a set of standardized products is in a more complex business than a bank.

Mr. GLAUBER. They, as you know, guarantee passthrough securities. They have off-balance sheet risks which are generally much larger than their on-balance sheet risks.

Senator HEINZ. In terms of size, but your argument wasn't about size. Your argument was about complexity.

Mr. GLAUBER. In terms of ratio, they are larger and, therefore, I think it makes their asset structure somewhat more complex. They also have access to the capital markets in ways different from most banks. Most banks, as you know, don't typically sell their instruments in a capital market; whereas, these do. So I think that, really, this is a different task from the banks. Indeed, Fannie Mae presented to us an analysis by James Wolfenson and Company arguing that the bank capital standards should not apply here, that these are very different beasts. And we accepted that argument.

We think they shouldn't, which is why we brought this proposal as we did. I think they really are different. And I think one can embrace this proposal for the GSE's without in any way rejecting what we do with banks, or vice-versa.

Senator HEINZ. Thank you very much.

The CHAIRMAN. Senator Pressler.

Senator PRESSLER. Thank you, Mr. Chairman. I welcome Mr. Glauber and look forward to his testimony and I may have some questions for the record. I thank you very much.

The CHAIRMAN. Very good.

A quorum has been achieved. We will be reporting favorably the nominations that we mentioned earlier.

Senator PRESSLER. I'm told that my presence made the quorum.

The CHAIRMAN. It is an important piece of work.

Let me say also I'm going to excuse you in just a moment, Mr. Glauber. We've got another important witness to follow you. When I was taking you through a few questions on the FIRREA legislation, one of the issues that has arisen recently is this question of loan to one borrower, which is, as you know, one of the top concerns about FIRREA. It tends to get mentioned most by outside parties of interest in terms of whether or not that may be creating some extraordinary difficulty.

Is it your impression that may be so, or do you tend to feel that things are working in that area about as well as they need to? And do you have a thought for us on that?

Mr. GLAUBER. We have received statements from and visits from a number of institutions and some number of groups suggesting that there are problems.

I think, in part, as they pointed out, there is no delayed effective date for those rules. It is our view and the view of OTS that there is considerable transition flexibility which for a while I don't think was understood by all of the participants.

OTS, I think, is working hard to make it clear that this transition authority does exist, and exploring further whether there is another transition authority that might be developed.

At this point, we feel comfortable with the provisions as they exist. OTS is working to make them work better. And I think that we ought to see whether they can do it.

The CHAIRMAN. Very good. Thank you very much for your testimony today. It has been very helpful to us. And, again, I want to say that we value the work that the Treasury is doing in this area, and we want to work with you on it as we go down the track.

Mr. GLAUBER. Thank you, Mr. Chairman. We look forward to continuing to do that.

The CHAIRMAN. Thank you.

Let me now call to the witness table the Assistant Comptroller General, Mr. Richard Fogel.

Mr. Fogel, we want to welcome you back and I know you have two associates with you, Ms. McCrory and Mr. Simmons. And we are pleased that they are here as well.

I'm going to call upon you in a moment to present a summary of your remarks. We'll make your full statement a part of the record.

I very much would like you to, of course, address in your comments what you think of the Treasury's proposals that we have just heard. You've sat through that testimony. I would like to get some reaction from you as to how you would regard some of the ideas that they put on the table today.

STATEMENT OF MR. RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC., ACCOMPANIED BY SUZANNE J. McCRORY AND CRAIG A. SIMMONS

Mr. FOGEL. Thank you very much, Mr. Chairman. We are pleased to be here today to discuss our preliminary findings on the GSE's.

As you know, FIRREA required us to assess four types of risks to which GSE's are exposed:

Interest rate risk, which is the possibility of losses from changes in interest rates; and GSE's that operate as portfolio lenders have a greater potential exposure to interest rate risk than GSE's that operate strictly as guarantors.

Credit risk, the possibility of losses from borrowers failing to repay their loans, or other parties like mortgage insurers failing to honor claims.

Business risk, which is the possibility of losses from factors largely beyond the GSE's control, such as crop failures from draughts or new legal requirements that may alter the way a GSE does business.

And, management and operations risk, which is the possibility of losses resulting from poor decisions or indecisiveness on the part of a GSE's managers.

Our preliminary work suggests that no GSE is in danger of immediate failure.

I would like to briefly describe each GSE's current risk exposure and its related control mechanisms.

From a consolidated perspective, the Farm Credit System was able to report profits in 1988 and 1989 after 3 years of losses caused by a serious agriculture recession and resulting loan defaults, high exposure to interest rate risk and management weaknesses.

Most of these profits have resulted from reversing loss reserves taken in prior years. The Agriculture Credit Act of 1987 provided system institutions up to $4 billion in Federal assistance, which has alleviated any immediate concern about system viability.

However, system institutions report that loan repayment is questionable for about 14 percent of their $49 billion in loans outstanding at the end of 1989. In addition, the Farm Credit Administration has identified weaknesses in the management of institutions that hold over 60 percent of the system's assets.

Furthermore, the system's health depends heavily on the general state of agriculture.

The Federal Home Loan Banks have historically presented little risk of failure. Their conservative lending policies provide a substantial cushion for losses. Future profitability, however, will be dampened because part of the Federal Home Loan Bank's earnings will be used to help pay the cost of thrift failures and to fund new affordable housing programs.

Fannie Mae faced financial trouble serious enough to result in losses for 4 years in the early 1980's. Legislation was enacted in 1982 that lengthened Fannie Mae's tax loss carryback period, qualifying it for refunds that a Fannie Mae official estimated to be about $25 million.

But, Fannie Mae was able to recover from its problems and posted record profits in 1989. Its financial difficulties resulted primarily from interest rate changes.

Freddie Mac has consistently reported profitable operations. Freddie Mac generally avoids interest-rate risk by limiting its portfolio lending, preferring instead to create mortgage-backed securities that pass interest rate risk on to the security investor.

Freddie Mac's credit losses is from its guarantees, have been generally lower than industry averages.

Sallie Mae's performance has been consistently profitable; because student loans are guaranteed by State agencies and the Federal Government, it has experienced minimal credit losses.

Connie Lee expects little or no losses from credit risk and is not exposed to interest rate risk in its current business of bond reinsurance.

And Farmer Mac has prepared credit standards but has not yet guaranteed any securities.

The day to day management and control of risk-taking is largely controlled by GSE managers and owners. For some GSE's, the Government protects its interest by monitoring GSE risk-taking, setting minimum capital levels and exercising enforcement authorities to prevent GSE's from continuing practices thought to be unsafe.

But, for other GSE's, the Government does very little to learn about unnecessary risk and guard against them.

The Farm Credit System and Farmer Mac are overseen by an independent Federal regulator, the Farm Credit Administration, which has established risk-based capital rules modeled after those applicable to commercial banks, 4 Farm Credit Banks and Banks for Cooperatives.

It also examines banks annually and has a full range of enforcement authorities.

The Federal Housing Finance Board regulates the Federal Home Loan Banks. It was created in August 1989. But, to date, no board members have been appointed. And the Secretary of the Department of Housing and Urban Development serves with the full power of the Board of Directors.

It is unclear how effective the Federal Housing Finance Board will be as an independent regulator for safety and soundness.

Fannie Mae is subject to oversight by HUD. And, last year in August, HUD received authority to oversee Freddie Mac. HUD does not have the full range of explicit enforcement authorities typically available to bank regulators and, probably just as important, never has used the audit authority it has to oversee Fannie Mae.

Indeed, in 1985, we reported to members of Congress that we didn't think HUD's regulation of Fannie Mae was adequate. And we made a series of recommendations to improve that, most of which were not implemented, by the way, to a satisfactory degree.

Furthermore, HUD officials told us and we agree that it is unclear whether HUD has authority to establish risk-based capital standards for Fannie Mae and Freddie Mac. They do, however, have the authority to require less capital than the statutory debt to capital formula specifies. But, the statutory debt-to-capital stand-

ards currently applied to Fannie Mae and Freddie Mac are not based on the risks they take.

The standard does not require capital to be held on their guarantees of $500 billion in mortgage-backed securities. Furthermore, although their portfolio lending operations expose them to interest rate risk, the standard does not require capital for such risk.

We are also concerned with the fact that the statutory capital standard is broadly defined to include owner equity, loss reserves, and subordinated debt equally.

In the final analysis, Fannie Mae and Freddie Mac can increase their risk without a commensurate increase in equity capital.

HUD officials say that, in the future, they plan to strengthen their monitoring and oversight of Fannie Mae and Freddie Mac. Nevertheless, we are concerned about inherent conflicts between HUD's housing policy goals and its goals as a financial regulator.

Recent history with the thrift crisis and the Farm Credit crisis has illustrated the disastrous effects of having regulators both promote the industry and be responsible for financial oversight.

Sallie Mae is not routinely overseen by any Federal agency, nor is it subject to federally established capital rules.

And Connie Lee, like insurers, is subject to State regulation that oversees its risk-taking and capital levels.

Our views are generally consistent with Treasury's in that we think, given the sheer size of financial obligations that the GSE's have, over $800 billion, their public purposes, and the probability that the Federal Government would assist a financially troubled GSE, it is appropriate for the Government to oversee the risk-taking activities and establish appropriate capital levels.

The situation we found is that the Government oversees some GSE's but not others. The agriculture enterprises and the Federal Home Loan Banks each have a regulator.

Connie Lee's activities, like those of other private insurers, are regulated by State authorities and appear to be disciplined by private creditors. However, Fannie Mae's, Freddie Mac's, and Sallie Mae's risk-taking in capital levels are not closely overseen by the Government.

Furthermore, GSE ties with the Government have weakened the discipline that creditors normally provide to completely private financial firms. With inadequate Federal oversight and weakened private market discipline, GSE risk-taking and capital are largely controlled by owners and managers.

In financially troubled times, after capital is depleted, owners and managers may have incentives to take unusual risks in a last ditch effort to recover. General creditors may be willing to lend GSE's the funds needed to take these unusual risks if they expect to be protected from loss by Federal assistance.

The farm credit and thrift crises vividly demonstrate the effects of inadequate Federal oversight of the risk-taking and capital of financial institutions. The Government did not have adequate monitoring capability or any capital rules in place to learn about the farm credit crisis in time to prevent it from becoming serious.

For thrifts, capital regulations were largely unenforced and oversight and supervision were weak.

As a result, the crisis reached unprecedented proportions.

After each financial crisis, legislation reformed and strengthened the supervisory role of the financial regulators, making them more independent and giving them responsibilities for establishing risk-based capital rules.

But, regulatory reforms were enacted too late to avoid large taxpayer losses. While we did not become aware of anything in our preliminary review to suggest that any GSE is in danger of immediate failure, prudence dictates that the Government not wait for a crisis before protecting its interests.

By strengthening oversight and establishing risk-based capital rules in the current favorable environment, potential for future financial crisis can be reduced.

So we need a better system of monitoring. We need some capital rules that are reasonable, and we need some appropriate enforcement authorities to ensure safety and soundness for Fannie Mae, Freddie Mac, and Sallie Mae.

We haven't reached a conclusion as to the precise way this can best be accomplished. And we will continue to do our analyses and develop these recommendations as we make our final report in 1991.

That concludes our prepared statement, Mr. Chairman.

[The complete prepared statement of Richard L. Fogel follows:]

United States General Accounting Office

GAO Testimony

For Release
on Delivery
Expected at
10 a.m. EDT
May 15, 1990

Risks and Oversight of Government Sponsored Enterprises

Statement of
Richard L. Fogel
Assistant Comptroller General
General Government Programs

Before the
Committee on Banking, Housing and
Urban Affairs
United States Senate

Risks and Oversight of Government Sponsored Enterprises

Summary of Statement By
Richard L. Fogel
Assistant Comptroller General
General Government Programs

In response to a request from the Honorable Donald W. Riegle, Jr., Chairman, Senate Committee on Banking, Housing and Urban Affairs, GAO presented its preliminary findings on the purpose and general activities of Government Sponsored Enterprises (GSE), the risks they face as well as those the government faces from a GSE failure, and the need for appropriate oversight and capital standards for GSEs.

GAO did not become aware of anything in its preliminary review to suggest that any GSE is in danger of immediate failure. Nevertheless, prudence dictates that the government not wait for a crisis before protecting its interests.

The government protects its interests in some GSEs through federal oversight, including monitoring of their risks, reasonable capital standards, and enforcement of safe and sound practices. This, however, is not the case for Fannie Mae, Freddie Mac and Sallie Mae. Furthermore, the close ties between the government and these GSEs weaken the discipline that creditors normally provide to private firms. The lack of appropriate federal or private discipline for these three GSEs make the federal government vulnerable to losses from any serious future GSE problems that may arise.

GAO believes that a better system of oversight, some reasonable risk-based capital rules, and appropriate enforcement authorities are needed for Fannie Mae, Freddie Mac and Sallie Mae. In general, this system needs to assure that the federal government obtains timely information on the risks undertaken by certain GSEs as well as proper oversight, including congressional oversight. This oversight should be designed to keep emerging problems from imposing losses on taxpayers and develop appropriate responses quickly so that major unanticipated losses can be contained. We have not yet formed an opinion on the precise way this can best be accomplished. We plan to continue our analysis and make recommendations in this regard in our final 1991 report.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our preliminary findings on government-sponsored enterprises (GSE). We share your concern about the safety and soundness of GSEs. They are very large financial organizations, established by Congress, that undertake a variety of risks to accomplish certain public policy purposes. Their operations have become critical to the finance of housing, agricultural, and student lending. The securities GSEs issue are perceived by investors to have safety comparable to U.S. Treasury securities. Given their public policy links to the government, a GSE experiencing serious financial difficulties could pose tough and possibly expensive decisions for the Congress, like those it faced during the Farm Credit and thrift crises. No one wants to see those experiences repeated.

Our preliminary work on GSEs has involved learning about their operations, the risks they face, and how they measure and control risks. We have also examined how they might transmit the risks they take to the government. My testimony today will describe the purpose and general activities of GSEs, the risks they bear, and how they are regulated. I will then discuss our concerns about the need for appropriate oversight and capital standards for GSEs.

GSEs--WHO THEY ARE, THE RISKS THEY BEAR, AND HOW THEY ARE OVERSEEN

GSEs were created by Congress to correct certain flaws in our financial system that made it difficult for creditworthy borrowers to finance homes, agricultural businesses, or college educations.

One major credit problem that GSEs were designed to solve was the uneven availability of credit throughout the country. When banks depended primarily on local deposits for their lending, creditworthy borrowers living in areas of rapid economic growth had trouble borrowing money when the local deposit base was insufficient to meet the lending demands. The national credit markets that GSEs created have helped to solve this problem.

Another problem that GSEs were designed to solve was the difficulty in attracting large-scale investment funds to agricultural, housing, or student lending. Large-scale investors tended to prefer investments in large denominations that could be easily converted into cash. However, mortgage, agriculture, and student loans tended to be small and could not easily be traded. Furthermore, the risks involved in such lending activities were hard to assess because lending practices varied throughout the country, the loan payments could be unpredictable, and the collection procedures could be difficult.

GSEs overcame these problems by offering securities attractive to large-scale investors and, in turn, making these investor funds available to local lenders who want to make mortgage, agricultural, or student loans.

GSEs can be grouped in a variety of ways. One way of grouping them is by their market sector--that is, agriculture, housing, or higher education lending. These market distinctions are important because the general economic climate of the market sector in which GSEs lend typically affects their financial health. Another grouping is by their operating style--portfolio lenders (which hold loans), guarantors, or those that use both techniques. Portfolio lenders borrow money at one rate and lend it at another. They can be vulnerable both to loan defaults and changes in interest rates. By contrast, guarantors enhance the credit quality of financial products for a fee. They are less vulnerable to changes in interest rates than portfolio lenders but equally vulnerable to loan defaults. Table 1 lists the GSEs that we studied, the year(s) each was created, its market sector, and its style of operations.

Table 1:

GSEs INCLUDED IN THIS STUDY

GSE Name	Year Created	Market Sector	Style of Operation
Farm Credit Banks	1916/ 1988	Agriculture	Portfolio lender
Banks for Cooperatives	1933	Agriculture	Portfolio lender
Federal Home Loan Banks	1932	Housing	Portfolio lender
Federal National Mortgage Association (Fannie Mae)	1938/ 1968	Housing	Portfolio lender and guarantor
Federal Home Loan Mortgage Corporation (Freddie Mac)	1970	Housing	Portfolio lender and guarantor
Student Loan Marketing Association (Sallie Mae)	1972	Education	Portfolio lender
College Construction Loan Insurance Association (Connie Lee)	1986	Education	Guarantor
Federal Agricultural Mortgage Corporation (Farmer Mac)	1988	Agricultural Real Estate	Guarantor

GSE Risk Exposure and Control Mechanisms

The Financial Institutions Reform, Recovery and Enforcement Act required that we study four types of risks to which GSEs are exposed:

-- Interest rate risk is the possibility of losses from changes in interest rates. GSEs that operate as portfolio lenders

have a greater potential exposure to interest rate risk than GSEs that operate strictly as guarantors.

-- Credit risk is the possibility of losses from borrowers failing to repay their loans or other parties, like mortgage insurers, failing to honor claims.

-- Business risk is the possibility of losses from factors largely beyond the GSEs' control, such as crop failures from droughts or new legal requirements that may alter the way a GSE does business.

-- Management and operations risk is the possibility of losses resulting from poor decisions or indecisiveness on the part of a GSE's managers.

GSEs deal with these risks in the normal course of business and use their existing capital to cover any losses they may incur. If the losses exceed available capital, the GSE could fail, thereby posing a problem for the government.

Our preliminary work suggests that no GSE is currently in danger of immediate failure. I will briefly describe each GSE's current risk exposure and its related control mechanisms:

-- From a consolidated perspective, the Farm Credit System of Farm Credit Banks, Banks for Cooperatives, and their related associations were able to report profits in 1988 and 1989 after 3 years of losses caused by a serious agricultural recession and resulting loan defaults, high exposure to interest rate risk, and management weaknesses. Most of these profits have resulted from reversing loss reserves taken in prior years. The Agricultural Credit Act of 1987 provided System institutions up to $4 billion in federal assistance which has alleviated any immediate concerns about System viability. However, System institutions report that loan repayment is questionable for about 14 percent of their $49 billion in loans outstanding at the end of 1989. In addition, the Farm Credit Administration has identified weaknesses in the management of institutions that hold over 60 percent of the System's assets. Furthermore, the System's health depends heavily on the general state of agriculture. Farm Credit institutions have recently developed systems that should enable them to better control their interest rate risk. In addition, new risk-based capital requirements are being phased-in that are somewhat analogous to those being implemented in the banking and thrift industries.

-- The Federal Home Loan Banks have historically presented little risk of failure. Their conservative lending policies provide

a substantial cushion for losses. Future profitability, however, will be dampened because part of the Federal Home Loan Banks' earnings will be used to help pay the costs of thrift failures and to fund new affordable housing programs.

-- Fannie Mae faced financial troubles serious enough to result in losses for 4 years in the early 1980s. Legislation was enacted in 1982 that lengthened Fannie Mae's tax loss carryback, qualifying it for refunds that a Fannie Mae official estimated to be $25 million. Fannie Mae was able to recover from its problems and posted record profits in 1989. Its financial difficulties resulted primarily from interest rate changes. Fannie Mae reports that its exposure to interest rate risk has been greatly lessened although not eliminated. Its losses from credit risk have also declined from unusually high levels experienced in the mid-1980s. Fannie Mae is rebuilding its capital base and has recently announced the planned addition of $2 billion in capital. It plans to hold capital sufficient to withstand, on a national basis, its default experience from mortgages originated in Texas in 1981 and 1982.

-- Freddie Mac has consistently reported profitable operations. Freddie Mac generally avoids interest rate risk by limiting its portfolio lending, preferring instead to create mortgage-backed securities that pass interest rate risk on to the

security investor. Freddie Mac's credit losses from its guarantees have been generally lower than industry averages. Freddie Mac's policy is to hold capital sufficient to absorb, for a period of at least 7 years, the effects of housing defaults comparable to those experienced during the Great Depression. Currently, Freddie Mac says it holds sufficient capital to withstand such losses for 10.5 years.

-- Sallie Mae's financial performance has been consistently profitable. Because student loans are guaranteed by state agencies and the federal government, it has experienced minimal credit losses. Its policy is to minimize losses from changes in interest rates by borrowing funds with interest rate payments that adjust parallel with the interest it earns on its student loans. Sallie Mae has decreased its capital holdings since 1984 from about 5 percent of assets to about 3 percent in 1989.

-- Connie Lee expects little or no losses from credit risk and is not exposed to interest rate risk in its current business of bond reinsurance. Connie Lee's capital is set by management to conform to private market standards for the highest quality bond insurers.

-- Farmer Mac has prepared credit standards and methods of operations but has not yet guaranteed any securities.

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Government's Oversight Approaches Vary

The day-to-day management and control of risk-taking is largely controlled by GSE managers and owners. For some GSEs, the government protects its interest by monitoring GSE risk-taking, setting minimum capital levels, and exercising enforcement authorities to prevent GSEs from continuing practices thought to be unsafe. But for other GSEs, the government does very little to learn about unnecessary risks and guard against them. Let me briefly describe how the government oversees GSE risk-taking and capital.

-- The Farm Credit System and Farmer Mac are overseen by an independent federal regulator, the Farm Credit Administration. The Farm Credit Administration has established risk-based capital rules, modeled after those applicable to commercial banks, for Farm Credit Banks and Banks for Cooperatives. It also examines Bank operations annually, and has a full range of enforcement authorities to stop System institutions from engaging in highly risky practices.

-- The Federal Housing Finance Board regulates the Federal Home Loan Banks. It was created in August 1989 with authority to monitor the risk-taking of Banks and enforce safe practices. To date, however, no board members had been appointed and the

Secretary of the Department of Housing and Urban Development (HUD) serves with the full power of the Board of Directors. Currently, it is unclear how effective the Federal Housing Finance Board will be as an independent regulator for safety and soundness.

-- Fannie Mae is subject to oversight by HUD. In August of 1989, HUD also received authority to oversee Freddie Mac when the Federal Home Loan Bank Board (Freddie Mac's former Board of Directors) was abolished. HUD does not have the full range of explicit enforcement authorities typically available to bank regulators and has never used the audit authority it has to oversee Fannie Mae. Furthermore, HUD officials told us, and we agree, that it is unclear whether HUD has authority to establish risk-based capital standards for Fannie Mae and Freddie Mac. They do, however, have the authority to require less capital than the statutory debt-to-capital formula specifies.

The statutory debt-to-capital standards currently applied to Fannie Mae and Freddie Mac are not based on the risks they undertake. As Table 1 noted, Fannie Mae and Freddie Mac operate both as portfolio lenders and as guarantors. The debt-to-capital standard requires that capital be held for borrowings they make as portfolio lenders. The standard does not require capital to be held on their guarantees of $500

billion in mortgage-backed securities. Furthermore, although their portfolio lending operations expose them to interest rate risk, the standard does not require capital for such risks.

We are also concerned with the fact that the statutory capital standard is broadly defined to include owner equity, loss reserves, and subordinated debt equally. From the government's perspective, owner equity represents the best protection to the government against unexpected losses because owners have incentives to protect their personal investment from losses. By contrast, loss reserves account for expected defaults and subordinated debt involves borrowings from creditors that must be repaid to avoid default. In the final analysis, Fannie Mae and Freddie Mac can increase their risks without a commensurate increase in equity capital.

HUD officials say that in the future they plan to strengthen their monitoring and oversight of Fannie Mae and Freddie Mac. Nevertheless, we are concerned about inherent conflicts between HUD's housing policy goals and its goals as a financial regulator. Recent history with the thrift crisis and the Farm Credit crisis has illustrated the disastrous effects of having regulators both promote the industry and be responsible for financial oversight.

-- Sallie Mae is not routinely overseen by any federal agency nor is it subject to federally established capital rules.

-- Connie Lee, like other insurers, is subject to state regulation that oversees its risk-taking and capital levels.

THE GOVERNMENT NEEDS TO IMPROVE ITS APPROACH FOR OVERSEEING CERTAIN GSEs

The sheer size of GSEs' financial obligations--over $800 billion--their public policy purposes, and the probability--in view of the precedents of Farm Credit and Fannie Mae--that the federal government would assist a financially troubled GSE, make it appropriate for the government to oversee their risk-taking activities and establish appropriate capital levels.

The situation that we found is that the government oversees some GSEs but not others. The agricultural enterprises and the Federal Home Loan Banks each have a regulator with certain authorities to monitor risk-taking and set capital rules. Connie Lee's activities, like those of other private insurers, are regulated by state authorities and also appear to be disciplined by private creditors. However, Fannie Mae's, Freddie Mac's, and Sallie Mae's risk-taking and capital levels are not closely overseen by the government. Furthermore, GSE ties with the government have weakened the discipline that creditors normally

provide to completely private financial firms because these ties provide investors with a reasonable assurance that their claims will be honored by the federal government should a GSE fail.

With inadequate federal oversight and weakened private market discipline, GSE risk-taking and capital are largely controlled by owners and managers. In financially troubled times after capital is depleted, owners and managers may have incentives to take unusual risks in a last-ditch effort to recover. General creditors may be willing to lend GSEs the funds needed to take these unusual risks if they expect to be protected from loss by federal assistance.

The Farm Credit and thrift crises vividly demonstrate the effects of inadequate federal oversight of the risk-taking and capital of financial institutions. The government did not have adequat monitoring capability or any capital rules in place to learn about the Farm Credit crisis in time to prevent it from becoming serious. For thrifts, capital regulations were largely unenforced, and oversight and supervision were weak. As a result, the crisis reached unprecedented proportions. After each financial crisis, legislation reformed and strengthened the supervisory role of the financial regulators, making them more independent and giving them responsibilities for establishing risk-based capital rules. But the regulatory reforms were enacted too late to avoid large taxpayer losses.

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While we did not become aware of anything in our preliminary review to suggest that any GSE is in danger of immediate failure, prudence dictates that the government not wait for a crisis before protecting its interests. By strengthening oversight and establishing risk-based capital rules in the current favorable environment, the potential for future financial crises can be reduced.

We think a better system of monitoring, some reasonable capital rules, and appropriate enforcement authorities are needed for Fannie Mae, Freddie Mac, and Sallie Mae. In general, this system needs to assure that the federal government obtains timely information on the risks undertaken by certain GSEs as well as proper oversight, including congressional oversight. This oversight should be designed to keep emerging problems from imposing losses on taxpayers and develop appropriate responses quickly so that major unanticipated losses can be contained. We have not yet formed an opinion on the precise way this can best be accomplished. We plan to continue our analysis and make recommendations in this regard in our final 1991 report.

That concludes my prepared statement. My colleagues and I would be pleased to answer any questions.

The CHAIRMAN. Let me thank you for it, and for the work that's underway. And I know that your work will be continuing and so you'll have more to say to us at a later point.

Do you have any reaction to the Treasury proposals that we just heard beyond what you've said in your own statement?

Mr. FOGEL. Well, I think, a couple.

No. 1, we applaud the Treasury Department for coming forth with some specific proposals because we think it does indicate a willingness on the part of the administration to try to get a better handle on what's going on with these GSE's.

We do have some concerns with the private rating proposal. That is certainly one way to go. I think our concern with that is that, regardless of whether you have a private sector firm do some of the rating or not, the Federal Government needs to understand what the assumptions were that went into the model and how the model was developed. Regardless of whether you have the private sector to do it, the Federal Government needs to, if you will, be able to audit how that was done to protect its interest in the GSEs.

So while we haven't fully even debated within the GAO the pros and cons of that, I think we'd be concerned if the Federal Government just absolutely turned the whole mechanism of assessing risk over to the private sector.

We support Treasury's position that there needs to be increased capital. We also agree that you can't apply the same standards to each GSE. They need to be looked at individually.

The CHAIRMAN. Now, have you begun to form an opinion, a professional opinion yourself as to whether or not we would need to have an independent regulator that might oversee the GSE's as a group? I mean, there are two ways—several ways you could do it. You could also have an independent regulator for each one separately.

But, you probably heard Mr. Glauber say that, in their mind, they thought that maybe the Fed would be a place where you could lodge this. I'm not sure the Fed would have much interest in wanting to take that on.

He mentioned the FDIC. The FDIC certainly is a busy place these days and has plenty of work to do without adding additional work.

He mentioned the Treasury Department. I'm not sure that that gives you the sort of independence that you would want with respect to an arm's length oversight apparatus.

But, what would be your reaction to any of those ideas, or the idea of maybe the need for, the wisdom of a freestanding regulator that would really look at the financial soundness questions and be charged with that responsibility?

Mr. FOGEL. I think all those are viable options. I would tend to agree with you. I'm not sure the Federal Reserve would want to take this on.

One of our concerns with the FDIC right now is they are very busy, not only with thrifts, but they need to be in there examining the banks. And we think the resources are stretched somewhat thin.

One of the key questions that has to be addressed in deciding where you would want to put a regulator revolves around what type of supervision or monitoring you want.

One of the key things is that the Government needs more information on what the GSE's are doing, what the risks are.

There is a possibility it could be put in Treasury. We haven't fully explored at this point in time exactly where you would do it. I think we would probably come down on the side of either an independent group or perhaps in the Treasury rather than looking to a bank regulator to supervise these GSE's.

The CHAIRMAN. But you're generally of the view, are you, that it's important to separate the actual promotion and general programatic regulation of a GSE from the question of how the financial aspects are supervised and, in a sense, overseen?

Is that——

Mr. FOGEL. Yes, absolutely. And it's based on experience. We have experience in the Farm Credit System. We don't think HUD has really looked at the GSE's from a safety and soundness standpoint. That's not what they do. So we do think they should be separated.

So, to that extent, we are in agreement with Treasury.

The CHAIRMAN. Do you have data with you today as to what the growth in the GSE's has been in the aggregate over the last, say, 4 or 5 years?

Or, said a different way, can you give us a sense for what the compound rate of growth is of the GSE's in aggregate size?

Ms. MCCRORY. I think it's about 20 percent annually, Mr. Riegle. We'll have to check that for you and get it for the record.

The CHAIRMAN. Well, actually, I've just been handed some data myself and it looks this way.

If you score this—this is based on information from the Congressional Budget Office, OMB, and Moody's Investor Service. And it shows a total for the Farm Credit System, for the Federal Home Loan Banks, for Freddie Mac, Fannie Mac, and Sallie Mae—those are the only ones included in this listing. They start out in 1970—so this would go back roughly two decades—at about $37 billion.

By 1975, they were up to $82 billion in the aggregate. By 1980, a decade later, they were up to $175 billion. So they had come from $37 billion to $175 billion in a decade.

In the decade since, they jumped up between 1980 and 1985, from $175 billion in 1980 to $402 billion in 1985. And then there's been a steady climb. Just to give it the year by year numbers: 1986—$507 billion; 1988—$619 billion; 1987—$720 billion; 1989 is $835 billion.

And that's where this particular chart leaves off.

So we've seen—assuming these numbers are——

Mr. FOGEL. They have grown very quickly over the last decade.

The CHAIRMAN. And I think it's probably a fair assumption to say that that rather explosive growth, other things being equal, would likely continue.

And, quite apart from the programmatic questions that raises, I think the question of making sure that we've got a discipline in place that looks after the safety and soundness of obligations in that dimension becomes pretty important.

We're approaching a trillion dollars there. And I think that certainly would suggest that we ought to be sure that we've got in place very rigorous regulatory mechanisms that can monitor this and keep track of it.

Mr. FOGEL. I agree. And to that extent, we and the Treasury are very consistent in saying it's important to explore this issue and try to get it resolved while things are calm and we're not in a crisis situation.

And if history is prologue, we don't want to get to the point where we were with either farm credit or the S&L crisis, where we try to deal with a problem once the crisis is upon us. It can be done in a much more reasoned, calm atmosphere.

And I think we both—we and the Treasury—I certainly know we in GAO feel very strongly that this is the time to explore how to develop better monitoring and supervisory systems, that don't necessarily have to be intrusive, but still let the Government have better information on the risk exposure of the GSE's

The CHAIRMAN. Well, that is exactly the view of this committee and of this chairman. And that is why we've been in a series of hearings moving into this so that we understand it clearly and that we've got the magnitude and possible ramifications out there for all to see and to evaluate.

And we're going to be very interested in what you are prepared to recommend yourselves. I know you're moving in the direction of developing some formal recommendations, I take it. Is that right?

Mr. FOGEL. We are. Our interim report will, pursuant to the statute, has to be sent out for comment to the GSE's and you will get a copy of that draft, in addition to Treasury, within the next week.

And then, over the next year, we are going to develop more specific recommendations. But we are certainly prepared in the interim to work with the committee to develop more legislative proposals.

I'm not sure that we have to wait until the spring of 1991 to come forward with proposals on how to strengthen monitoring and supervision.

The CHAIRMAN. Yes. And certainly it would be my thought to not necessarily be bound by that kind of a time table. It seems to me that we're pretty well into it now.

It's interesting as well that the FIRREA legislation had a lot of components to it. And one component part was precisely to structure a way to get at this kind of careful and systematic assessment and decide what might need to be done in other areas of the Government.

I think this is one of the important aspects of the requirements of that law, although it certainly doesn't generate front page news. But we hope, if we do it right, it won't generate front page news.

Mr. FOGEL. Precisely. That's why it was a good provision to enact into law.

The CHAIRMAN. Now, let me ask you this. We have received reports on Freddie Mac and Fannie Mae that have been done by Price Waterhouse and by Wolfensohn respectively that judge their capital to be adequate, with certain caveats. I'm wondering if you've had a chance to look at those reports and do you find that kind of outside assessment to be satisfactory in and of itself?

Mr. FOGEL. We have looked at those reports. And, again, as Mr. Glauber said, we found some positive aspects in both reports.

However, we don't see those as substitutes for the Federal Government finding out on its own what the adequacy of the situation of the GSE's are.

We haven't gone in behind that. We don't know about the quality of the data that the GSE's provided to either group to do the studies. I think they both said in their reports that they didn't audit the data. And while it's always important to get outside views that way, we don't think that those types of studies substitute for direct analyses by the government over time.

The CHAIRMAN. Now, based on your current level of evaluation, do you see any red flag situations in any of the GSE's that you should bring to our attention?

Mr. FOGEL. No. We don't think any of them are in any immediate problems. The system that we have the most concern about, quite frankly, is the Farm Credit System. And it basically has to do with the fact that the safety and health of that system revolves around the agriculture sector.

And if we have problems again, there could be a problem there. The structure is in place with the Farm Credit Administration to deal with the problem. But you've still got the banks that are under some type of enforcement action with the regulator now that have 60 percent of the loans.

So we've got a little problem there. But, even the Farm Credit System isn't in any immediate danger.

The CHAIRMAN. Let me ask you in a different area. I know you have a large number of analytical efforts underway at any time. And we've certainly asked you to do a great number from the point of view of this committee.

Do you have anything going on at the moment that you could reference in some way as to how things look out in the commercial banking system at the moment?

Mr. FOGEL. I'd like to let Mr. Simmons address that.

Mr. SIMMONS. We are doing a job on the condition of the commercial banking industry. We have had considerable difficulty, quite frankly, Mr. Chairman, with the tapes, and the quality of the data that we've gotten from the regulators.

And we had hoped to have a report out this month on the condition of the industry. It looks now like we will be prepared to comment on it in late summer or early fall.

The CHAIRMAN. That's quite a difference. I mean——

Mr. SIMMONS. Yes, it is. Well, by this fall, we will have another quarter's worth of data. I'm sure you're aware there's also quite a time lag in the information between the time that the banks file and the time that it's made available by the regulators.

But, at any rate, we do intend to have a report and we'll certainly be prepared to comment on the condition of the industry later on this summer and fall.

The CHAIRMAN. Well, tell us a little more about the problem with the tapes or the data. That's somewhat surprising.

Mr. SIMMONS. Frequently, from one quarter to the next, the bank counts seem to be off. In some cases, they can be off by as many as a hundred banks.

The CHAIRMAN. Do you mean they just don't show up on the data?

Mr. SIMMONS. The counts of the numbers of banks. That's right. They disappear from one quarter to the next—when we try to get explanations from the regulators as to what the discrepancy is, sometimes we get answers and sometimes we don't.

What we generally do in those cases is look at other totals, size, gross amount of assets and that sort of thing, and decide whether it's a significant enough problem to make us worry about the conclusions that we could potentially reach.

Usually, it isn't serious enough to adversely, affect a conclusion we had reached one way or the other. But, when it is, we have to track it down, get to the bottom of it and get it corrected.

Mr. FOGEL. We also have several other efforts underway. As you know, we have to report on the financial condition of the FDIC fund and that should be ready I think later this month or early in June. And as Mr. Siedman has said the fund is not as healthy as it was. I think that's well known.

We also have an effort under way looking at the quality of bank supervision. One of the things, quite frankly, that has concerned us over the past year or so is the fact that all the regulators have had to supply some people to deal with the thrift problem.

And we knew from previous work that the timing of some of the bank examinations wasn't even what the regulators hoped it would be. So, we're in there now looking at the quality of that supervision.

Mr. SIMMONS. Let me just add this.

In that study, I think the thing that we want to emphasize in the supervision study is the question of enforcing capital regulations because at the end of the day, based on our experience with Farm Credit System and with the thrift industry, it seems to me that the focus has to be on capital. Indeed, much of this hearing has been focused on capital adequacy of GSE's. So that will be the principal focus of the bank supervision job.

The CHAIRMAN. Now, I want to take another minute on the FDIC fund. I shouldn't infer, I would think, from your earlier comment, that the data you are having trouble getting on banking generally would carry over into this area. I mean, you're getting the information you need here.

Mr. FOGEL. No, it doesn't.

The CHAIRMAN. My understanding is the last estimate that we received, I believe from Mr. Siedman, was that we had about $13 billion or so in the FDIC fund. Is that about right?

Mr. SIMMONS. I think that's about right, if I recall, yes.

The CHAIRMAN. And so the analysis that you hope to have done by the end of this month or within a month?

Mr. FOGEL. It's within a month, I think.

The CHAIRMAN. It will tell us up through what date the fund balance is?

Mr. FOGEL. Through the end of 1989.

The CHAIRMAN. And so through the end of 1989. There's a lag there of the better part of 5 or 6 months then?

Mr. FOGEL. That's correct, because, you see, we have to do an end of the year financial audit of the fund.

The CHAIRMAN. But do you have an ability to be on more a real time basis at that at the same time? Do you have measuring devices that let you reach forward beyond the end of 1989?

Mr. FOGEL. Our opinion has to be based on the condition of the fund at the end of 1989. I know that our accountants working on this are concerned just about that issue because we're dealing with a very dynamic situation.

And I think they're trying to get a handle on that. But I'd have to get back to you on the extent to which we're going to be able to comment on that in June.

The CHAIRMAN. Well, it would be my hope, you know, to the extent that year-end data tells us one thing and current data might tell us something else that is different enough that it would be important to know, that some effort be made to try to obviously discharge the year-end balance sheet report but, at the same time, give us a more up-to-date assessment if there's relevant information that ought to be brought to our attention.

Mr. FOGEL. We'll try to do that for you.

The CHAIRMAN. I'm going to give you some other questions for the record. And I know that other members of the Committee have some questions as well that they will want to give to you.

But we appreciate your work. It is very important. As I have said to you a number of times in the past, I think that this agency of Government is one of the most important that we have and I appreciate the work.

And I want you to pass those feelings along to your colleagues if you would.

Mr. FOGEL. I will. Thank you very much.

The CHAIRMAN. Very good. Thank you.

The committee stands in recess.

[Whereupon, the hearing was concluded.]

[Response to written questions follows:]

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

October 5, 1990

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

Robert R. Glauber

Question 1:

This is the first of two reports you are required to make on this subject. The next is due a year from now. How do you plan to extend your work in the next 12 months?

Answer:

Our first report was a comprehensive case study examination of the financial safety and soundness of GSEs.

At this point, for our second report, we plan to update our analysis of the financial performance of the GSEs, including any new developments that might affect the financial safety and soundness of the GSEs. For example, we will assess the impact on Sallie Mae from the recent failure of the Higher Education Assistance Foundation (HEAF), and the impact on Connie Lee from its planned entry into the direct insurance business.

We would welcome any guidance the Committee might provide.

Response to Questions
from Senator Riegle

Question 2:

Your suggestion that GSEs be required to maintain a triple-A rating is a very interesting one, but it raises a number of questions.

o Have the private rating agencies proven sufficiently accurate that we could rely on their judgement alone?

o You claimed that such a requirement would not significantly impair the ability of GSEs to fulfill their public purposes. Is that true for all of the GSEs you studied? On what analysis do you base your conclusion?

Answer:

The Treasury study recommends that GSEs be required to obtain a rating equivalent to triple-A, absent any implicit Government guarantee, from at least two of the nationally recognized credit rating agencies. We believe that the approach used in private markets to evaluate and monitor risks can and should be used to evaluate GSE risk, and that this approach provides a flexible method for evaluating risk that is superior to reliance on a single fixed capital adequacy standard.

Private rating agencies have an outstanding track record in assessing the risks of default for large and small corporations, including financial firms whose lines of business are comparable to many GSEs. In April 1990, Moody's released a study titled Corporate Bond Defaults and Default Rates, 1970-1989 which assessed its track record in rating over 3,000 bond issuers in the industrials, utilities, financial institutions, sovereign, and structured finance sectors. The study found that of the 274 rated issuers that defaulted from 1970 through year-end 1989, only one company defaulted on investment-grade debt. There were no defaults by triple-A or double-A rated issuers.

The requirement that GSEs maintain a triple-A rating does not have to impair the ability of GSEs to fulfill their public purposes. The strongest argument for our proposal is the capital flexibility that the use of credit rating agencies provides. In addition to capital, a rating agency would consider factors similar to what it normally does in rating a private firm, for example, the current status and outlook for: industry risk and market strategy, management, asset quality, operational performance, liquidity, and profitability. Thus, achieving the appropriate level of safety and soundness is not just a function of capital alone. The flexibility of the rating approach allows a GSE to improve its level of safety and soundness by improving on other aspects of its business if needed.

An example of how the rating agency approach allows for flexibility in the operations of a GSE and its approach to its public purpose is the lack of impact on low- and moderate-income housing programs of Fannie Mae and Freddie Mac. Because low income housing support is perceived as being inherently riskier compared to their other activites, some GSEs have stated that our proposal would cause curtailment of these programs. FIRREA directed Fannie Mae and Freddie Mac to undertake low- and moderate-income housing initiatives only if such activities provided a reasonable economic return to the companies. At your Subcommittee's roundtable hearing on August 2, 1990, Leland Brendsel, Chairman of the Board and CEO of Freddie Mac, stated that Freddie Mac's low- and moderate-income housing initiatives could be, and should be, structured such that they would not be significantly more risky than its normal lines of business. Thus, by structuring low- and moderate-income housing initiatives such that they are profitable and not excessively risky, Fannie Mae and Freddie Mac can continue to fulfill their public purpose without being penalized by rating agencies.

Question 3:

You argue for a separate implementor of safety and soundness standards, independent of an agency's programmatic regulator. How would you resolve potential conflicts between the two?

Answer:

The programmatic regulator would be responsible for ensuring that the activities of each GSE fulfill its public purpose. The safety and soundness regulator would be responsible for ensuring that the GSEs' activities meet high credit standards, thereby reducing the potential need for another costly Federal rescue and to ensure the long-term solvency of GSEs.

Unless Congress made a determination to the contrary, ensuring the safety and soundness of a GSE's operations should be paramount in the Federal Government's role as overseer of GSE activities. New programmatic initiatives would first have to be assessed within the framework of the safety and soundness of each GSE to ensure that these new activities would not expose the taxpayer to an undue amount of risk.

Response to Questions
from Senator Riegle

Question 4:

How well do current regulatory arrangements for the various GSEs meet your standard of independence? Does the Federal Housing Finance Board qualify? The Farm Credit Administration?

Answer:

The current regulatory arrangements for the various GSEs do not meet our proposed standard that the program regulator be different from the implementer of financial safety and soundness standards. Under the current regulatory system, the Department of Housing and Urban Development regulates the activities of Fannie Mae and Freddie Mac. The Federal Housing Finance Board and the Farm Credit Administration are responsible for regulating the Federal Home Loan Banks and the Farm Credit System institutions, respectively. Sallie Mae and Connie Lee do not have Federal regulators. In each of the cases where a regulator for a GSE exists, the regulator is responsible for both programmatic and safety and soundness regulation.

Treasury believes that by separating these two regulatory functions, the risk of a regulatory conflict of interest will be minimized. That is why FIRREA divided the thrift regulator's chartering and chief supervisory functions from its insurance function, assigning the former to the Office of Thrift Supervision and the latter to the FDIC.

Question 5:

In preparing your study, did you receive full and prompt cooperation from each of the GSEs you investigated?

Answer:

Most of the GSEs which were studied did provide Treasury with full and prompt cooperation. However, as Under Secretary Glauber testified at his May 15 appearance before the Senate Banking Committee, Treasury experienced difficulty in securing necessary information from a few GSEs. While Treasury does not anticipate having such problems during the second study, the Department will keep Congress informed as to its progress in obtaining information from the GSEs during the study.

Response to Questions
from Senator Riegle

Question 6:

Many of these sponsored agencies compete directly or indirectly with banks and thrifts. Do their operations have any implication for our deposit insurance risks?

Answer:

It is certainly true that one effect of the activities of a number of the GSEs has been to increase competition for some banks and thrifts. For instance, the tremendous growth that has occurred in the secondary market for home mortgages has made it easier for mortgage originators to obtain credit and make more loans. Banks and thrifts have probably seen spreads on their mortgage loans narrowed because of this increased competition. On the other hand, banks and thrifts have also derived significant benefits from the secondary market, particularly in the liquidity opportunities it provides. Moreover, as mortgage loans have become more standardized and data on default histories have become available, mortgage lenders have been able to do a better job of understanding and pricing the risk of their loans.

On balance, while it is not clear how the operations of GSEs have affected deposit insurance risks, we believe the added liquidity in mortgage-related instruments that has resulted from Fannie Mae and Freddie Mac operations may have reduced the risks.

Response to Questions
from Senator Riegle

Question 7:

In the absence of any new legislation, do you believe Treasury should take a somewhat broader view of its statutory authority to approve or prohibit new debt issues, rather than merely serving as a "traffic cop" to help in the scheduling of new offerings?

Answer:

We believe that legislation is necessary to implement our proposed principles. While the current statutory provisions applicable to GSEs do contain some authority for Treasury oversight with respect to debt issues, the language of these statutes is not consistent and does not explicitly provide for broad regulatory oversight by Treasury. Furthermore, the "traffic cop" function is the most frequently cited rationale for Treasury approval over debt issues, and Treasury, in fact, has a history of limiting the exercise of its authority to that function. Any attempt to use the Treasury approval authority over debt issues for broad regulatory purposes would likely be met with legal challenges, thus tying up any attempted regulation in a burdensome litigation process.

Response to Questions
from Senator Riegle

Question 8:

We have received reports on Freddie Mac and Fannie Mae done by Price Waterhouse and Wolfensohn, respectively, that judge their capital to be adequate, with certain caveats. Have you had a chance to inspect these reports? Did you find them useful?

Answer:

Both the Price Waterhouse and Wolfensohn reports were made available to us by Freddie Mac and Fannie Mae while we were preparing the Treasury's report on Government-sponsored enterprises. We found them useful in their presentation of how Freddie Mac and Fannie Mae evaluate their capital adequacy.

In the Treasury report, we noted that Price Waterhouse's discussion of the thrift risk-based capital rules could be misleading. The Price Waterhouse report stated that Freddie Mac "... meet[s] the thrift industry capital standard, as modified by us to reflect Freddie Mac's interest rate and portfolio risk and geographical dispersion..." The problem with this statement is that the modifications are so substantial that the rule Price Waterhouse applied is no longer the thrift risk-based capital rule. For example, one change to the thrift capital rules the Price Waterhouse study made was to measure Freddie Mac's capital on a marked-to-market basis, rather than GAAP.

The Wolfensohn report presented capital ratios that Fannie Mae believes are appropriate. The Treasury report noted that application of these ratios to Fannie Mae at year-end 1989 indicated that Fannie Mae considered itself to be approximately $1 billion below its optimal capital level at that time. We also noted that guidelines, such as these, are not the same as an outside discipline, such as regular scrutiny by private credit rating services, that encourages prudent risk management.

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General Government Division

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
RICHARD L. FOGEL

Q.1. Your testimony indicates that you are unsure whether the newly created Federal Housing Finance Board will be effective as an independent regulator, even after a full board is appointed. What are your concerns about the structure of this new agency?

A.1. Our most immediate concern is the length of time it has taken to appoint members to the Federal Housing Finance Board. Until the Board members are appointed and assume their duties, we find it difficult to assess the strategic direction that this new regulatory agency will take. We also note that the Federal Housing Finance Board has potentially conflicting responsibilities for both supervising the safety and soundness of the Federal Home Loan Banks and for ensuring that they carry out their housing finance mission. How these dual responsibilities will be carried out cannot yet be determined.

Q.2. This is the first of two reports you are required to make on this subject. The next is due a year from now. How do you plan to extend your work in the next 12 months?

A.2. We have one principal goal during the second phase of this assignment--to propose a specific regulatory design for GSEs, including more specific features of a risk-based capital rule for those GSEs without one. To make a specific proposal, we believe that we will need to evaluate various organizational alternatives, structures, and authorities, including the Treasury's proposal that government-sponsored enterprises be required to obtain triple-A ratings from two national rating agencies.

We will also need to complete specific study requirements not fully addressed in our first report--including an evaluation of the quality of GSE information available to the public and the government; and the impact, if any, of the operation of the government-sponsored enterprises on borrowing of the federal government.

ENCLOSURE

We also hope to have resources available to evaluate the implementation of risk-control procedures that the government-sponsored enterprises use.

Q.3. You argue for a separate implementor of safety and soundness standards, independent of an agency's programmatic regulator. How would you resolve potential conflicts between the two?

A.3. In principle, we believe that safety and soundness regulation must take precedence because failure of a government-sponsored enterprise would have serious financial consequences and would obviate ongoing achievement of the enterprise's public policy purposes.